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No. —

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

JURISDICTIONAL STATEMENT

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QUESTIONS PRESENTED

1. Whether, under the "unitary business" test laid down by this Court in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223 (1980), New Mexico's inclusion in Appellant's apportionable business income of dividends paid to Appellant by functionally independent foreign subsidiaries contravenes the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States.

2. Whether New Mexico's inclusion in Appellant's apportionable business income of an amount equal to the "deemed paid" foreign tax credit allowed by the Federal government with respect to those dividends contravenes the Due Process Clause.

3. Whether New Mexico's inclusion of the dividends and "deemed paid" foreign tax credit in apportionable business income contravenes the Commerce Clause of Article I, Section 8 of the Constitution.

4. Whether, if some portion of the dividends or "deemed paid" foreign tax credit may constitutionally be included in Appellant's apportionable business income, the Due Process Clause will still be violated unless a correlative adjustment is made to New Mexico's apportionment factor.

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TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

JURISDICTIONAL STATEMENT

OPINIONS BELOW

The opinion of the Supreme Court of the State of New Mexico (the "New Mexico Supreme Court") is reported as *Taxation & Revenue Dept., etc.* v. *F. W. Woolworth,* 624 P.2d 28 (N.M. 1981). The opinion of the Court of Appeals of New Mexico (the "New Mexico Court of Appeals") is reported as *F. W. Woolworth* v. *Bureau of Revenue of N.M.,* 624 P.2d 51 (N.M. App. 1979). Included as Appendix A, *infra,* are copies of those opinions (App. A, *infra,* pp. 1a-22a and pp. 23a-29a, respectively) and the unreported Decision and Order of the Director of the Revenue Division of

the Taxation and Revenue Department of the State of New Mexico (the "New Mexico Taxation and Revenue Department") (App. A, *infra,* pp. 30a-38a).

JURISDICTION

This proceeding involves the application of New Mexico's Income Tax Act and Uniform Division of Income for Tax Purposes Act to (1) certain dividends which Appellant received from four of its foreign subsidiaries, and (2) the related foreign tax credits which Appellant claimed on its Federal income tax return for foreign taxes actually paid by the foreign subsidiaries. As is more fully described below, the New Mexico Taxation and Revenue Department upheld the asserted deficiencies whereupon Appellant took an administrative appeal to the New Mexico Court of Appeals. The New Mexico Court of Appeals reversed. However, this decision, in turn, was reversed by the New Mexico Supreme Court which rejected both Appellant's statutory challenge and constitutional challenge. Included as Appendix B, *infra,* are copies of the final Order of the New Mexico Supreme Court, dated January 30, 1981, and the Mandate of the New Mexico Court of Appeals, dated February 6, 1981.

Included as Appendix C, *infra,* is a copy of the Notice of Appeal which Appellant filed in the New Mexico Supreme Court on March 30, 1981.[1] This Jurisdictional Statement is being filed within 90 days of January 19, 1981, the date on which the New Mexico Supreme Court rendered its opinion upholding the constitutionality of the New Mexico statute as applied to Appellant. Accordingly, this Court has jurisdiction

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[1] Appellant also filed a copy of the Notice of Appeal in the New Mexico Court of Appeals on March 30, 1981.

under 28 U.S.C. § 1257(2). *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223 (1980) (hereinafter referred to as *"Mobil"*); *Moorman Mfg. Co.* v. *Bair,* 437 U.S. 267 (1978).

STATUTE INVOLVED

Sections 7-2-2(S), 7-2-2(T), 7-4-2(A), 7-4-3, 7-4-5, 7-4-8, 7-4-10, and 7-4-11 of the New Mexico Statutes 1978, Annotated ("N.M.S.A. 1978") are set forth in Appendix D, *infra.*[2]

STATEMENT OF THE CASE

F. W. Woolworth Co., the Appellant, is a New York corporation engaged in the retail business throughout the United States, Puerto Rico, and the Virgin Islands. It purchases a variety of consumer items (including dry goods, hardware, appliances, candy and some packaged food) and sells them at retail through Woolworth and Woolco stores. Most, if not all, of the stores also serve fountain items and meals. (App. A, *infra,* pp. 2a, 32a)

During its fiscal year in issue, which ended January 31, 1977 ("fiscal 1977"), Appellant received $39,881,161 in dividends from four of its foreign subsidiaries: F. W. Woolworth and Co., Limited, a 52.7 percent owned English subsidiary; F. W. Woolworth Co. GmbH, a wholly-owned German subsidiary; F. W.

[2] These statutory references are to the New Mexico statute as recodified in 1978 since these are the statutory provisions referred to in the opinion of the New Mexico Supreme Court. The substantive provisions, however, are the same as those in effect during the period in issue and were not amended or changed as part of the recodification.

Woolworth, Limited, a wholly-owned Canadian subsidiary; and F. W. Woolworth S.A. de C.V. Mexico, a wholly-owned Mexican subsidiary. (App. A, *infra*, pp. 26a, 33a, 35a)

These four subsidiaries are in the same general type of business as is Appellant, operating retail stores in their respective countries. They do no business, however, in New Mexico or elsewhere in the United States. In addition, as the record shows, their retail businesses are separate and distinct from Appellant's retail business in the United States. Each subsidiary carries on its own business autonomously and independently. Each subsidiary makes and carries out its own decisions with respect to size and location of stores, type of merchandise to be sold, advertising, accounting, personnel training and policies,[3] inventory purchases, and other operating procedures. Even where Appellant and its subsidiaries purchased inventory items in the same countries abroad (*e.g.*, in the Orient), the purchasing was done independently. (App. A, *infra*, pp. 33a-34a; Tr. 55-59)[4]

As a consequence of operating independently, each subsidiary conducts its retail business in a manner which varies from country to country, thereby responding to local tastes and needs. For example, in England, many of the stores have a restaurant and cafeteria as well as a supermarket section where food is sold. In Germany, there is an emphasis on soft goods

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[3] During the year in issue, none of the officers of the foreign subsidiaries was currently or formerly an employee of Appellant. (App. A, *infra*, p. 34a)

[4] The "Tr." reference is to the Transcript of the proceeding before the New Mexico Taxation and Revenue Department.

(such as dresses, clothing and coats, etc.) with no food selling operations. There also are differences in advertising methods from country to country. (App. A, *infra,* pp. 33a-34a; Tr. 56)

As noted by the New Mexico Supreme Court, Appellant, as the sole or major shareholder, has the power to control its foreign subsidiaries and has exercised some of this power as a consequence of carrying on the normal stewardship functions of a controlling shareholder. (App. A, *infra,* pp. 8a-9a) For example, Appellant had interlocking directors with some of the subsidiaries' Boards of Directors. Appellant also has performed some oversight functions and has determined the amount of the subsidiaries' dividend payments. (App. A, *infra,* pp. 8a-9a) The New Mexico Supreme Court also stated in its opinion, however, that "[t]here is some flow back and forth of goods and financial resources." (App. A, *infra,* p. 9a). Insofar as "goods" are concerned, this statement is simply inaccurate, contradicted by the record (Tr. 57, 95-98) and not based upon the findings of the Hearing Examiner of the New Mexico Taxation and Revenue Department (App. A, *infra,* pp. 33a-35a). The only references in the record or the Hearing Examiner's findings to a "flow" of "financial resources" involved Appellant's initial capital investments in the subsidiaries, small loans which may have been made to the English subsidiary,[5] and the dividends paid by the subsidiaries to Appellant. (App. A, *infra,* p. 35a; Tr. 61-63, 75-76, 79-83, 98-99)

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[5] In any event, such loans, if made, were repaid well before fiscal 1977, the year in issue. (Tr. 99)

Appellant elected on its Federal income tax return to claim credits rather than deductions for its foreign taxes. See sections 901 *et seq.* in subpart A of part III of subchapter N of the Internal Revenue Code (the "Code"). Consequently, under section 902(a) of the Code, Appellant was deemed, for purposes of the foreign tax credit provisions of the Code, as having paid a portion of the foreign taxes actually paid by the foreign subsidiaries from which Appellant received dividends. Such foreign taxes paid by a foreign subsidiary give rise to a "deemed paid" or "indirect" foreign tax credit. In addition, under section 78 of the Code, the amounts of such deemed paid credits were treated, for purposes of the Code, as dividends received by Appellant from the respective foreign subsidiaries.[6] This dividend treatment is commonly referred to as the "section 78 gross-up" or "gross-up".[7] In this case, Appellant's gross-up amounted to $25,502,782 for fiscal 1977, the taxable year in issue. (Tr. 171)

In filing its New Mexico tax return for fiscal 1977, Appellant apportioned its operating business income between sources within and without New Mexico on the basis of the three-factor formula prescribed by section 7-4-10, N.M.S.A. 1978. (See App. D, *infra,* p. 46a) This three-factor formula apportioned to New

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[6] Sections 902(a) and 78 of the Code are set forth in Appendix E, *infra.*

[7] For example, if a foreign subsidiary earns $100, pays foreign tax of $40, and pays a dividend of $30 out of its after-tax profits of $60, the "deemed-paid" foreign tax credit under section 902 is 30/60 x $40, or $20. The United States recipient includes $50 in dividend income (*i.e.*, the actual dividend of $30 plus $20 of "gross-up") and claims a foreign tax credit of $20 against the Federal income tax on this income.

Mexico that fraction of Appellant's total "business income" which was the average of the fractions of Appellant's total tangible property, payroll and sales attributable to New Mexico. Appellant did not include either its dividends from its foreign subsidiaries (*i.e.*, $39,881,161) or the related "gross-up" amount (*i.e.*, $25,502,782) in its apportionable business income.[8] Instead, Appellant allocated the dividends to New York, its commercial domicile, pursuant to section 7-4-8, N.M.S.A. 1978. (App. D, *infra*, p. 46a) Appellant's apportionable business income and New Mexico taxable income for fiscal 1977 were reported as $18,274,068 and $84,622, respectively. (Tr. 115)

On audit, the New Mexico Taxation and Revenue Department determined that (1) all of Appellant's dividends, gross-up, interest, and foreign exchange gain were includible in apportionable business income, and (2) the inclusion of these items in apportionable business income did not warrant any correlative decrease in Appellant's apportionment factor. Because of the large amounts involved, this adjustment increased Appellant's New Mexico taxable income from $84,622 to $401,518 for fiscal 1977. (Tr. 122)

Relying on both statutory and constitutional grounds, Appellant challenged the inclusion of the dividend,

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[8] Initially, Appellant also excluded $2,350,141 of interest and $1,595,551 of foreign exchange gain from its apportionable business income. (Tr. 43, 115.) At the outset of the proceeding before the New Mexico Taxation and Revenue Department, Appellant agreed to the inclusion of the interest in apportionable business income. (Tr. 41.) However, since the foreign exchange gain resulted from a hedging transaction whereby Appellant hedged the value of its investment in its English subsidiary, Appellant believes that disposition of this foreign exchange gain issue should be the same as the disposition of the dividend issue. (Tr. 43)

gross-up and foreign exchange gain in apportionable business income and, alternatively, the absence of appropriate factor modification. As indicated above, the New Mexico Court of Appeals upheld Appellant's primary statutory arguments concerning the measure of apportionable business income (thereby reversing the decision of the New Mexico Taxation and Revenue Department) without reaching the constitutional issues. (App. A, *infra,* pp. 23a-29a) This decision, in turn, was reversed by the New Mexico Supreme Court which rejected both Appellant's statutory and constitutional arguments. (App. A, *infra,* pp. 1a-22a)

REASONS FOR NOTING JURISDICTION

This case involves substantial constitutional issues. First, as is discussed more fully below, there is a need for this Court to resolve a conflict among the states and to clarify the constitutional limits of the "unitary business" test in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont, supra.* In addition, other constitutional issues are presented here which were not considered or resolved in this Court's decisions in *Exxon Corp.* v. *Wisconsin Dept. of Revenue,* 447 U.S. 207, 100 S.Ct. 2109 (1980) or *Mobil.* For example, Appellant's alternative contention concerning the constitutional requirement for some adjustment to the apportionment factor in a case such as this was specifically identified and deliberately left unresolved by this Court in *Mobil.*

(1) Under the "Unitary Business" Test Laid Down by this Court in *Mobil,* New Mexico's Inclusion of the Dividends in Issue in Appellant's Apportionable Business Income Contravenes the Due Process Clause.

In *Mobil* this Court was confronted with the question of whether, under the Due Process Clause, a

nondomiciliary state (Vermont) could constitutionally tax (by inclusion in apportionable income) certain dividends received by a resident corporation [9] (Mobil) from other nonresident corporations having no contact with the taxing state. Based on this Court's preliminary determination that the business activities of the nonresident, dividend paying corporations were functionally integrated with Mobil's unitary petroleum business which, in part, was conducted in Vermont, the Court upheld the constitutionality of the Vermont tax as applied to Mobil, stating (100 S.Ct. at 1232-1233):

> "[T]he linchpin of apportionability in the field of state income taxation is the unitary business principle. In accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. *Bass, Ratcliff & Gretton* [266 U.S. 271 (1924)] forecloses the contention that the foreign source of the dividend income alone suffices for this purpose. Moreover, *appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from its petroleum sales activities in Vermont.* Indeed, all indications in the record are to the contrary, *since it appears that these foreign activities are part of appellant's integrated petroleum enterprise . . . Vermont was entitled to conclude that the dividend income's foreign source*

[9] As used hereinafter, the term "resident" corporation means a corporation which is doing business within the taxing state, but is organized under the laws of some other state and has its headquarters or commercial domicile in some other state.

did not destroy the requisite nexus with instate activities."

* * *

"Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. *So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability."* [Footnotes deleted; emphasis supplied]

It is apparent from the opinion of the New Mexico Supreme Court in this case and the March 4, 1981 opinion of the Idaho Supreme Court in *American Smelting & Refining Co.* v. *Idaho State Tax Commission* [10] that further clarification is needed from this Court on how to apply the "unitary business" test of *Mobil*. As shown by the cases discussed below, there is a conflict among the states at this time.

We think it plain that the test adopted by this Court in *Mobil* is whether the "underlying activity"—that is, the business of the dividend-paying corporation—is part of a "functionally integrated enterprise" being conducted, in part, by the resident corporation in the

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[10] The initial decision of the Idaho Supreme Court in *American Smelting* was in March, 1979, and is reported at 592 P.2d 39. This Court subsequently vacated that decision and remanded the case "for further consideration in light of" *Mobil. ASARCO, Inc.* v. *Idaho State Tax Commission*, 445 U.S. 939, 100 S.Ct. 1333 (1980). On remand, however, the Idaho Supreme Court simply issued a one paragraph, per curiam opinion reinstating its prior opinion. A copy of this recent opinion, dated March 4, 1981, is contained in Appendix F, *infra*.

taxing state. We also think it plain that Appellant's unitary business (*i.e.*, its retail business conducted throughout the United States, Puerto Rico, and the Virgin Islands) and the separate businesses of its dividend-paying foreign subsidiaries (*i.e.*, their retail businesses conducted in their respective countries) are not functionally integrated. As discussed above (pp. 4-5), each subsidiary carries on its own business autonomously and independently, making and carrying out its own decisions with respect to size and location of stores, type of merchandise to be sold, advertising, accounting, personnel training and policies, inventory purchases, and other operating procedures. (App. A, *infra*, pp. 33a-34a; Tr. 55-59)

Appellant's interpretation of the "unitary business" test in *Mobil* is also supported by *Square D Co.* v. *Kentucky Board of Tax Appeals*, 415 S.W.2d 594 (Ky. 1967) and *Gulf Oil Corp.* v. *Clayton*, 267 N.C. 15, 147 S.E.2d 522 (1966). In both cases, because the business operations of a parent and subsidiary were not integrated, the businesses were not treated as parts of a unitary business even though there was common ownership and both corporations were engaged in the same type of business. See also *American Bakeries Co.* v. *Johnson*, 259 N.C. 419, 131 S.E.2d 1 (1963).[11]

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[11] Similarly, where two businesses of a single corporation are not functionally integrated, the two businesses do not constitute a single unitary business. See, *e.g.*, this Court's opinion in *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, *supra*. In that case, income derived from the sale of crude oil and gas to third parties at the wellhead was excluded from the apportionable income of Exxon's unitary petroleum business. See also *Commonwealth* v. *Advance-Wilson Industries, Inc.*, 317 A.2d 642 (Pa. 1974), where a single corporation conducted two different businesses, a ceramic tile business and an electrolyzing business, which were held to be separate

It is apparent, however, that the New Mexico Supreme Court has applied a different test in this case. Rather than look to whether the "underlying activities" of the dividend paying subsidiaries were functionally integrated with Appellant's business, the court has focused on Appellant's powers and status as the controlling shareholder of its subsidiaries.[12] As described above (p. 5), the court emphasized Appellant's stewardship activities (as the controlling shareholder), including representation on some of the subsidiaries' Boards of Directors and determination of dividend payments. Such activities, however, are perfectly consistent with Appellant's assertion that there was no functional integration of Appellant's retail business with the retail businesses of the subsidiaries. Thus, these stewardship activities are insufficient to cause the dividends received by Appellant from its foreign subsidiaries to be part of Appellant's apportionable business income from the conduct of its retail business in New Mexico (or any other nondomiciliary state). These dividends lack the requisite "nexus" with New Mexico. *Moorman Mfg. Co.* v. *Bair, supra.*

It is important for this Court to resolve the conflict among the states and to clarify the constitutional limits of the "unitary business" concept. In view of this case

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businesses. It did not matter that both businesses were conducted as divisions of the same corporation so that there was common ownership and control, or that the home office performed certain administrative and other functions for both divisions

[12] This approach is consistent with the approach taken by the Idaho Supreme Court in its initial opinion in *American Smelting.* As is discussed in footnote 10, *supra,* that opinion was reinstated following the remand from this Court.

and the recent Idaho opinion, there is an obvious need for this Court to now do what the Idaho Supreme Court failed to do on remand—that is, to give further consideration to the unitary business test "in light of" *Mobil*. In this regard, Appellant has been authorized by ASARCO, Inc. to state here that ASARCO intends to appeal again to this Court from the decision of the Idaho Supreme Court. Thus, this Court will have ample opportunity to fully consider and clarify the unitary business test of *Mobil*.

(2) New Mexico's Inclusion of the Section 78 Gross-Up Amount in Appellant's Apportionable Business Income Contravenes the Due Process Clause.

The treatment of the Federal section 78 gross-up is a substantial issue which warrants this Court's attention. The issue potentially arises in those states where (a) a corporation's Federal taxable income is used as the starting point in determining the corporation's apportionable business income, and (b) there is no additional, corrective statutory provision which provides for the deduction of the section 78 gross-up. At the present time eleven states (including New Mexico) have statutes which satisfy both of these conditions.[13]

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[13] Thirty-three states satisfy the first condition—*i.e.*, they use Federal taxable income as the starting point in determining apportionable business income. Sixteen of these states have solved the section 78 gross-up problem by also enacting legislation which specifically provides for a deduction of the gross-up. Another six states deduct dividends generally from taxable income, thereby (presumably) also deducting the gross-up. See, *e.g.*, *Dow Chemical Co.* v. *Commissioner of Revenue*, 391 N.E.2d 253, 263-266 (Mass. 1979). Under section 78 of the Code, the gross-up is treated as a dividend from the foreign corporation. In *Dow*, therefore, the Court accepted this characterization of the gross-up as a "divi-

In addition, other states are attempting to tax the gross-up in taxable years not covered by new legislation which may have cured the problem prospectively. See, *e.g., Caterpillar Tractor Co.* v. *Lenckos,* 77 Ill. App.3d 90, 395 N.E.2d 1167 (1979) which was affirmed by the Illinois Supreme Court (Nos. 52818, 52828 and 52903, decided February 20, 1981).

As a general proposition, Appellant does not dispute a nondomiciliary state's use of a resident corporation's Federal taxable income in determining the corporation's apportionable business income.[14] However, where that Federal taxable income contains a section 78 gross-up amount, some further adjustment is constitutionally required. The inclusion of this admittedly "fictional amount" (App. A, *infra,* p. 3a) in apportionable business income at the state level inevitably contravenes the Due Process Clause by apportioning to the nondomiciliary state an amount which is "out of all appropriate proportion to the business transacted . . . in that state." *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell,* 283 U.S. 123, 135 (1931).

Under section 78 of the Code, a corporation's deemed-paid foreign tax credit (*i.e.,* the gross-up amount) is

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dend" and allowed a deduction of the gross-up under the provision in the Massachusetts statute providing for the deduction generally of dividends. Appendix G, *infra,* contains a chart showing which states base their taxable income on Federal taxable income, and which states also have enacted provisions either deducting the section 78 gross-up specifically or dividends generally.

[14] Appellant recognizes the legitimate objectives of doing this "for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co.* v. *Taxation and Revenue Dept.,* 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

"treated" as a dividend only when the corporation claims a credit (rather than a deduction) for its foreign taxes.[15] Prior to the enactment of section 78 in 1962, the election to claim a foreign tax credit did not require this inclusion of the gross-up amount in taxable income. The legislative history to section 78 clearly and explicitly states that the sole purpose for the change was to increase the United States parent corporation's effective overall tax rate on the income of its foreign subsidiary in those instances in which the parent corporation claimed foreign tax credits. Thus, the issue was not to measure the taxpayer's "gross income" or "taxable income". The issue was to achieve a mechanism which, taking into account the corporation's foreign tax credit, would arrive at the appropriate overall tax rate for Federal income tax purposes. See S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 66-71 (1962-3 C.B. 707, 772-777) and H. Rep. No. 1447, 87th Cong., 2d Sess., pp. 50-53 (1962-3 C.B. 405, 454-457) which accompanied the Revenue Act of 1962, P.L. 87-834, 76 Stat. 960.

The question, therefore, is whether, under these circumstances, a nondomiciliary state can take this fictional amount into account in determining the taxable income of a resident corporation from the corporation's activities in the state. Appellant's foreign tax credit election on its Federal income tax return should be irrelevant to New Mexico's determination of Appellant's taxable income in New Mexico. The value of its activities in New Mexico is unrelated to this elec-

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[15] Obviously, if the gross-up truly constituted an item of income, it would have been unnecessary to enact section 78 in order to achieve that "treatment".

tion. For New Mexico to increase Appellant's apportionable business income by $25,502,782 as a consequence of Appellant's Federal foreign tax credit election makes no sense, results in an excessive apportionment to New Mexico, and is constitutionally infirm. *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission,* 390 U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra.*

In view of the New Mexico Supreme Court's reliance on the Vermont decision in *F. W. Woolworth* v. *Commissioner of Taxes,* 130 Vt. 544, 298 A.2d 839 (1972)[16] it is ironic that the clearest support for Appellant's position now comes from Vermont. The Vermont Supreme Court did initially hold in *Woolworth* that the section 78 gross-up could be treated as income because, as a consequence of making its foreign tax credit election on its Federal income tax return, the taxpayer realized the economic benefit of reducing its overall Federal income tax liability. However, that decision was overrruled and repudiated by the Vermont Supreme Court in its recent decision in *In re Appeal of Norris Knosher* (No. 203-80, decided February 3, 1981).[17]

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[16] See App. A, *infra,* pp. 5a-6a.

[17] Under the Vermont statute in issue in *Knosher,* the taxpayer's Vermont income tax liability was defined as 25 percent of his Federal income tax liability, determined without regard to the new credit provided for in section 51 of the Code for wages paid to certain employees. In determining his Federal tax, Mr. Knosher claimed the credit, thereby also reducing his deduction for wages. See section 280C of the Code. The issue, therefore, was whether, for Vermont income tax purposes, Mr. Knosher could redetermine his Federal tax liability as though he had not claimed the credit,

It is also important to note that, as part of its 1972 *Woolworth* opinion, the Vermont Supreme Court also required the Commissioner to adjust the apportionment formula to reflect the activities of the foreign subsidiaries whose dividends gave rise to the gross-up. See 298 A.2d at 845-846. The New Mexico Supreme Court refused to give the same apportionment formula relief in this case. Thus, even if Vermont's decision in *Woolworth* still had vitality, it would not support the *result* in this case.

Nor, insofar as the constitutional issue presented here is concerned, is there any other support for the result below. In *Dow Chemical Co.* v. *Commissioner of Revenue, supra,* for example, Dow's taxable income was not increased by the gross-up since the gross-up was deducted under the Massachusetts statute as a dividend. See footnote 13, *supra.* Thus, the constitu-

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but, instead, had claimed a larger deduction for wages. In deciding for the taxpayer, the court also held (Slip. Op. 3):

> "We believe that our holding in the present case is inconsistent with our earlier decision in *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972). *Woolworth* concerned the interpretation of a different statutory provision and was not cited by the Department, but the issue is analogous to that of the case at hand. Justice Larrow, in a dissenting opinion in a later related case, criticized the reasoning in *Woolworth, F. W. Woolworth* v. *Commissioner of Taxes*, 133 Vt. 93, 100, 328 A.2d 402, 407 (1974). We find his dissent more persuasive than the opinion in the earlier *Woolworth* decision, and do not consider that decision to be controlling in the case at hand. To the extent that the opinion in *F. W. Woolworth* v. *Commissioner of Taxes, supra,* 130 Vt. 544, 298 A.2d 839 (1972), is inconsistent with our decision in the present case, it is overruled."

tional issue presented here was not reached."[18] Similarly, in *Caterpillar Tractor Co.* v. *Lenckos, supra,* the constitutional issue was not reached because it was not presented to the court; the only issue was one of statutory construction.

Finally, even if this Court should conclude that the section 78 gross-up may constitutionally be included by a nondomiciliary state in income, there is the further question of whether the gross-up may constitutionally be included in apportionable business income. In this regard the New Mexico Supreme Court stated (App. A, *infra,* pp. 7a-8a):

> "We reverse the decision of the Court of Appeals which, in effect, would give Woolworth a deduction from the line 30 figure without statutory authority on the grounds that gross-up is not in fact dividend income and cannot be classified as 'business income.' We do not think the question involves a determination of whether the income is classified as 'business income.' Rather, we hold that it involves consideration of a statute that is constitutional, unambiguous and not subject to statutory construction. *See Hutchinson* v. *State,* 89 N.M. 501, 554 P.2d 663 (1976)."

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[18] However, in this regard, it is instructive to note the Massachusetts Supreme Judicial Court's statement that (391 N.E.2d at 265):

> "The gross-up-foreign tax credit symbiosis is a means of calculating a suitable Federal tax credit for the United States parent and in truth it is a strain to deal with any part of it as 'income' for state purposes."

In the same vein, the New Mexico Supreme Court, in its opinion below, referred to the section 78 gross-up as "a fictional amount representing 'dividends deemed to have been received'" and as "the fictitious gross-up." (App. A, *infra,* pp. 3a, 5a)

Appellant disagrees. The answer to the preliminary question of whether the section 78 gross-up may be treated as income does not answer the further question of whether the gross-up may be treated as part of the apportionable business income of Appellant's unitary business. Appellant contends that there is no connection between *its* domestic retail business and the fictional gross-up for foreign taxes paid by its foreign subsidiaries.

(3) New Mexico's Inclusion of the Dividends and the Section 78 Gross-Up Amount in Apportionable Business Income Also Contravenes the Commerce Clause.

The dividends: Mobil also involved the application of the Commerce Clause. Mobil argued that (100 S.Ct. at 1234):

> ". . . Vermont's tax imposes a burden on interstate and foreign commerce by subjecting [Mobil's] dividend income to a substantial risk of multiple taxation."

Mobil premised this "multiple taxation" argument on the assumption that all of its dividend income was fully taxable in the state of commercial domicile and, therefore, any apportionment to Vermont unavoidably subjected Mobil to the risk of multiple taxation at the state level. In deciding the Commerce Clause issue against Mobil, this Court rejected the premise for Mobil's argument. That is, the Court rejected Mobil's assumption that the dividends would necessarily be subject to tax in the state of commercial domicile.

Appellant's "multiple taxation" argument goes beyond Mobil's and, therefore, was not dealt with by this Court. Mobil's argument centered on the "risk" of multiple taxation by both the state of commercial

domicile and another nondomiciliary state. Here, however, as was found below (App. A, *infra*, pp. 31a-32a), Appellant actually paid foreign withholding taxes on its foreign source dividends.[19] In such a case, *any* state taxation (even by the state of commercial domicile) "creates more than the *risk* of multiple taxation: it creates multiple taxation in fact." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 99 S.Ct. 1813 (1979).

The section 78 gross-up: New Mexico's taxation of the gross-up simply exacerbates an already unconstitutional situation by increasing the discriminatory treatment of dividends from foreign subsidiaries. Assume, for example, that a domestic subsidiary had Federal taxable income of $100 on which it paid a Federal income tax of $46. If the subsidiary then paid the balance ($54) to its corporate parent, New Mexico would include at most $8.10 in apportionable business income (*i.e.*, $54 less the 85 percent dividends received deduction allowed by the Code).[20] By contrast, if the same subsidiary were a foreign subsidiary which paid $46 in foreign taxes and the corporate parent claimed

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[19] In this regard, see Income Tax Act sub-s 212(2) and 215(1) (Canada); EStG §§ 20(1) No. 1, 43(1) No. 1, 50(5) and KStG § 50(2) No. 2 (Germany); and Income Tax Law, Articles 60, V and 73, I (Mexico) which subject dividends to a tax which is imposed on the recipient, but withheld by the payor. England has a more complicated procedure which has the same effect as a withholding tax and need not be summarized here.

[20] The dividends received deduction would be available because of New Mexico's utilization of the Federal tax base. If the corporations filed a consolidated return or were eligible for the 100 percent dividends received deduction, no portion of the dividend would be includible by New Mexico in apportionable business income.

a credit for foreign taxes, New Mexico would include $100 in apportionable business income (*i.e.*, the full dividend of $54 plus the gross-up of $46). There would be no double taxation at the Federal level because of the accompanying foreign tax credit. Obviously, however, there is excessive taxation at the state level. There would be multiple taxation of the income of the foreign subsidiary as well as multiple taxation of the income of the United States parent. Under these circumstances, the New Mexico statute places an impermissible burden on foreign commerce. The statute discriminates against foreign commerce and impairs Federal uniformity in regulating commercial relations with foreign governments. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977); *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276 (1976).

(4) If Some Portion of the Dividends or Gross-Up May Constitutionally Be Included in Appellant's Apportionable Business Income, the Due Process Clause Will Still Be Violated Unless a Correlative Adjustment Is Made to New Mexico's Apportionment Factor.

As noted above, this issue was deliberately and explicitly left unresolved in *Mobil*. On three separate occasions, the majority opinion states that the issue was not considered because Mobil did not raise it. See 100 S.Ct. at 1230, 1233, n. 15 and 1237. Mr. Justice Stevens' dissent in *Mobil* makes it clear, however, that he would require an adjustment to the apportionment factor in a case like this. In this regard, his dissent states (100 S.Ct. at 1243):

> "Unless the sales, payroll and property values connected with the production of income by the [dividend] payor corporations are added to the denominator of the apportionment formula, the inclusion

> of earnings attributable to those corporations in the apportionable tax base will *inevitably* cause Mobil's Vermont income to be overstated." [Emphasis added]

The reason for Mr. Justice Stevens' conclusion is clear. A nondomiciliary state can properly tax a resident corporation only on that portion of its income which is attributable to its activities in the nondomiciliary state. In determining that amount, it should make no difference whether the corporation's unitary business is conducted through operating divisions or separately incorporated subsidiaries. As this Court stated in *Mobil* (100 S.Ct. 1233):

> "Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441, 84 S.Ct. 1564, 1568, 12 L.Ed.2d 430 (1964). *Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.*" [Emphasis supplied]

The results of operating a taxpayer's unitary business through a subsidiary will *not* be the same, however, as the results of operating through a division unless the taxpayer's apportionment factor is appropriately adjusted when dividends paid by the subsidiary are included in apportionable business income.[21]

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[21] This can be demonstrated by assuming that the taxpayer conducts a unitary business through two divisions (Division A, which

Thus, unless the taxpayer's apportionment factor is adjusted when dividends are included in apportion-

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operates both inside and outside New Mexico, and Division B, which operates entirely outside New Mexico). Assume the following figures:

	Division A		Division B	
	All Locations	New Mexico Situs	All Locations	New Mexico Situs
Property	$200,000	$20,000	$100,000	-0-
Sales	400,000	40,000	200,000	-0-
Payroll	200,000	20,000	100,000	-0-
Business Income	$ 20,000		$ 10,000	

On these facts, the income apportionable to New Mexico would be $2,000 computed as follows:

Total Business Income $30,000

New Mexico Factors:

$$\left[\frac{\text{Property } 20{,}000}{300{,}000} + \frac{\text{Sales } 40{,}000}{600{,}000} + \frac{\text{Payroll } 20{,}000}{300{,}000} \right] \div 3 = 6\tfrac{2}{3}\%$$

New Mexico Taxable Income = $30,000 × .06⅔ = $2,000

However, if the business of Division B were operated through a wholly-owned subsidiary corporation, and all income of the subsidiary were distributed as a dividend to the parent and treated as apportionable business income without any adjustment in the parent's apportionment factor, the income apportioned to New Mexico would be increased by 50% to $3,000, computed as follows:

Parent's Business Income = $20,000 + 10,000 =$30,000

Parent's New Mexico Factors:

$$\left[\frac{\text{Property } 20{,}000}{200{,}000} + \frac{\text{Sales } 40{,}000}{400{,}000} + \frac{\text{Payroll } 20{,}000}{200{,}000} \right] \div 3 = 10\%$$

New Mexico Taxable Income = $30,000 × .10 = $3,000

able business income (in order to reflect the subsidiary's payroll, sales and property which generated the dividends), the result will inevitably violate the Due Process Clause by apportioning too much income to the taxing state.[22] *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission, supra; Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra; People el rel. Alpha Portland Cement Co.* v. *Knapp,* 230 N.Y. 48, 129 N.E. 202 (1920).

Absent any appropriate adjustment to the apportionment factor, the nondomiciliary state will, in effect, be taxing directly a portion of the subsidiary's income—all of which was earned by activities conducted outside the nondomiciliary state. Such taxation of "extraterritorial values" is far different from taking the subsidiary's dividends into account, as part of the overall apportionment procedure, for the purpose of determining a parent corporation's income from its activities conducted within the taxing state. *Butler Bros.* v. *McColgan,* 315 U.S. 501, 507 (1942).

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[22] In this case, for example, New Mexico's inclusion of foreign source dividends and the gross-up in Appellant's apportionable business income for fiscal 1977 caused an increase from $18,274,068 (as initially reported) to $83,658,011. This increase, coupled with New Mexico's failure to adjust appropriately the apportionment factor, caused Appellant's New Mexico taxable income to be increased from $84,622 to $401,518. (Tr. 115)

The New Mexico Taxation and Revenue Department did include the amount of Appellant's dividend income and gross-up in the denominator of the sales fraction. But this token adjustment was plainly inadequate to reflect the subsidiaries' underlying sales, assets and payroll which produced the distributed income and clearly would have been taken into account had the businesses been run in a division of Appellant rather than in subsidiaries.

Finally, it is important to note that *Mobil* only involved the inclusion of dividends in apportionable business income. This case also involves the inclusion of $25,502,702 of section 78 gross-up in Appellant's apportionable business income. As the Vermont Supreme Court recognized in its *Woolworth* decision, the need to adjust the apportionment factor is particularly compelling when gross-up is involved. Thus, this case presents an excellent opportunity for this Court to consider fully the relationship between the determination of the apportionable income base and the apportionment fraction.

CONCLUSION

For the foregoing reasons, this Court should note probable jurisdiction of the appeal.

Respectfully submitted,

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Original filed 1-19-81

APPENDIX A

IN THE SUPREME COURT OF THE
STATE OF NEW MEXICO

No. 12,876

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, Petitioner,

vs.

F. W. WOOLWORTH COMPANY, a New York corporation, Respondent.

ORIGINAL PROCEEDING ON CERTIORARI

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OPINION

EASLEY, Chief Justice

Woolworth appealed to the Court of Appeals a decision of the New Mexico Taxation and Revenue Department (Department) which assessed additional corporate income taxes for fiscal year 1976-77. The Court of Appeals reversed the Department. We reverse the Court of Appeals.

There are three issues: (1) whether "gross up", meaning the foreign income taxes paid by Woolworth's foreign subsidiaries which Woolworth is required to report as dividend income in its federal income tax return in order

to claim a tax credit for those foreign taxes paid, is legitimately a part of the tax base upon which New Mexico income taxes are to be calculated; (2) whether the cash dividends Woolworth receives from its foreign subsidiaries are "business income" and therefore assessable for New Mexico income tax purposes; and (3) whether the facts and law here warrant a modification of the apportionment formula.

Woolworth, a New York corporation engaged in selling general merchandise at retail throughout the United States, has four subsidiary foreign corporations which are relevant here. Its German, Canadian and Mexican subsidiaries are wholly owned by Woolworth; and Woolworth owns 52.7% of its English subsidiary.

One legal writer has depicted the tangle of competing principles involved in these issues as a "lofty plateau of complexity." We agree. The first move to finding a way out of this maze is to isolate the first issue on gross-up from the other two, which the Court of Appeals failed to do.

I. Gross-up.

The literal meaning of the term "gross-up" has been lost in the labyrinth. However, it is used here to refer to the option an American multinational corporation has under the federal income tax law to claim credit for income taxes paid to foreign governments by its foreign subsidiaries. I.R.C. §§ 901-908. It results in a federal tax benefit to the corporation based on an adjustment made to federal taxable income. It must be recognized, however, that the New Mexico tax laws do not specifically confer the same benefit to the taxpayer.

The election with which we are concerned is that foreign taxes paid by a domestic corporation may be either deducted by the taxpayer (I.R.C. § 164(a)(3)) or credited against the tax due to the federal government (I.R.C. §§ 78

and 901-908). "In making these elections, the taxpayer has, presumably, lessened its federal income tax liability." *Caterpillar Tractor Co. v. Lenckos*, 77 Ill.App.3d 90, 395 N.E.2d 1167, 1176 (1979). As stated in *F. W. Woolworth Co. v. Commissioner of Taxes of State*, 133 Vt. 93, 328 A.2d 402, 404 (1974):

> The purpose of "gross-up" is to avoid giving the domestic corporation both a credit and a deduction for the foreign tax deemed paid on its federal income tax return, which would otherwise result from the allowance of a full credit against tax liability computed only on the dividend paid.

We deem it unnecessary to delve into all the intricacies of the federal laws and regulations. Suffice it to say that, since Woolworth decided to use the gross-up option, the income taxes paid by Woolworth's foreign subsidiaries to foreign governments must be deemed to be received as dividends and the amount must be added into gross income and be reflected in the slot on the tax return form from which federal income taxes are calculated. Treas. Reg. § 1.78-1 (1979).

Woolworth does not and cannot quarrel with the soundness of the inclusion of gross-up in the gross income figure on its federal income tax return which, at Woolworth's own deliberate and knowing option, contains a fictional amount representing dividends "deemed to have been received." Gross-up amounts to over $25,000,000 in this case, on which the Department is claiming unpaid taxes on the amount of income apportioned to New Mexico.

Thus, the important starting point is the figure of gross income. This necessarily includes gross-up, which must also be calculated in determining the amount placed on line 30 for "Taxable Income" on Federal Income Tax form No. 1120, filed by Woolworth for the 1976-77 tax year and on which federal taxes were payable.

The next step is to interrelate these federal statutes and rules with the New Mexico law. Section 7-2-2(S), N.M.S.A. 1978 establishes a "piggy-back" method of determining state taxable income by reference to federal law. It provides:

> "[B]ase income" [on which state taxes are calculated] means that part of the taxpayer's income generally defined as federal taxable income and upon which the federal income tax is calculated;

The New Mexico tax return form calls for the insertion of federal taxable income as the starting point for calculating state taxable income. "This is done for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co. v. Taxation & Revenue Dept.*, 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

It is clear that the taxable income figure entered on line 30 of form 1120, which must reflect the addition of gross-up in gross income, is the only amount that may be used in calculating Woolworth's taxes due in New Mexico. Most states that have enacted income tax laws define taxable income in the identical manner.

Nevertheless, Woolworth in this case did not add gross-up into the New Mexico taxable income amount, upon which Woolworth paid taxes to the State of New Mexico. The Department claimed a deficiency in taxes paid. Woolworth appealed to the Court of Appeals, which erroneously sustained Woolworth's position.

Woolworth does not deny that the combined federal and state laws mandate that gross-up be reflected as state taxable income. But, it argues that the figure is artificial, that inclusion of the additional amount in apportionable income is inequitable, and that the tax administrator has the au-

thority to cure the inequity "pending a legislative amendment." (There seems to be a tacit admission in this phrase that legislative action is probably necessary.) Woolworth further states that the administrator's authority is contained in the statute which permits a modification of the apportionment formula. The company also urges that gross-up is not income because that term means acquisition of an economic benefit. A due process constitutional issue was raised on the theory that if gross-up is included in taxable income, Woolworth is entitled to deduct the amount of any taxes paid or deemed paid. The basis of the Court of Appeals' ruling was that gross-up is not dividend income and could not be classified as "business" income.

These issues have been answered against Woolworth's contentions in a number of cases. Admittedly, the fictitious gross-up, which the state claims is "business income" and which Woolworth deliberately acceeded to, does not fit the ordinary definition of "income":

> But a state has the power to gauge its income tax by reference to the income on which the taxpayer is required to pay a tax to the United States. The constitutionality of state statutes which refer to the Internal Revenue Code definitions have been upheld by the courts. See, *Garlin v. Murphy*, 51 Misc.2d 477, 273 N.Y.S.2d 374 (1966), aff'd 34 N.Y.2d 921, 359 N.Y.S.2d 552 (1974); *Thorpe v. Mahin*, 43 Ill.2d 36, 250 N.E.2d 633 (1969); 85 C.J.S. Taxation § 1096b; Annot., Constitutionality, construction, and application of provisions of state tax law for conformity with Federal income tax law or administrative and judicial interpretation, 166 A.L.R. 516 (1947), supplemented in 42 A.L.R.2d 797 (1955) and its supplement.

Champion International Corp. v. Bureau of Revenue, 88 N.M. 411, 416, 540 P.2d 1300, 1305 (Ct. App. 1975), *cert. denied*, 89 N.M. 5, 546 P.2d 70 (1975). In *F. W. Woolworth*

Company v. Commissioner of Taxes, 130 Vt. 544, 298 A.2d 839 (1972), the court held:

> Appellant contends that gross-up does not fit into the definition of "income" under the decisions of the United States Supreme Court that there must accrue, at the very least, some economic benefit or accession to wealth to the taxpayer before he can be said to have realized "income." There is no finding that by the election to use the gross-up rule the appellant did not realize an economic benefit. It clearly appears from the record, however, that the contrary is shown to be the fact. Woolworth's Vermont and federal income tax returns disclose that it gained a decided tax advantage dollarwise by exercising the option to use gross-up as a credit on its federal tax liability.
>
> Construing the provisions of the pertinent tax statutes, we conclude it was the clear intent of the legislature that appellant's tax base must include the gross-up.

298 A.2d at 844. There is no claim and no finding that Woolworth did not obtain an economic benefit from the gross-up procedure here.

In *Caterpillar, supra*, the court examined several of the same complaints made here and found that after making an election which presumably lessened the taxpayer's federal income tax liability, the taxpayer was trying to reverse the effect of that election. The court stated:

> Federal net income is certainly a reasonable starting point for determining corporate net income for Illinois income tax. (Citation omitted.) As a result of their own elections, the plaintiffs have not deducted the amount of foreign taxes from and have added certain hypothetical income to their gross income, and for federal income tax purposes, they are bound by those elections. Nothing in our existing Illinois law can be

> found to relieve the plaintiffs of the consequences of their choices for Illinois income tax purposes. (Citation omitted.) The granting of such a deduction is a privilege created as a matter of legislative grace, and no one is entitled to a deduction not clearly allowed by statute, the burden being on the taxpayer to demonstrate entitlement to the claimed deduction. (Citation omitted.)

395 N.E.2d at 1176-77.

The Illinois court held further that a court has no authority to create such a deduction. In our case the Court of Appeals effectively created a deduction that is not warranted by the statutes. *See Albany Intern. Corp. v. Helperin*, 388 A.2d 902 (Me. 1978); *see also Dow Chemical Co. v. Commissioner of Revenue*, 391 N.E.2d 253 (Mass. 1979).

Dow rejected the argument that Subpart F income was not income under the Sixteenth Amendment of the United States Constitution, citing *Estate of Whitlock v. C.I.R.*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (1974).

In *Getty Oil Co. v. Taxation and Revenue Department, supra* at 593, 603 P.2d at 332 (Ct. App. 1979), the court said: "It is our further opinion that the phrase 'federal taxable income and upon which the federal income tax is calculated' is unambiguous and self-explanatory." We agree.

We reverse the decision of the Court of Appeals which, in effect, would give Woolworth a deduction from the line 30 figure without statutory authority on the grounds that gross-up is not in fact dividend income and cannot be classified as "business income." We do not think the question involves a determination of whether the income is classified as "business income." Rather, we held that it involves consideration of a statute that is constitutional,

unambiguous and not subject to statutory construction. *See Hutchinson v. State*, 89 N.M. 501, 554 P.2d 663 (1976).

II. Stock Dividends From Foreign Subsidiaries as "Business Income"

In addition to deducting gross-up from its taxable income on the New Mexico income tax return, as discussed in the first point, Woolworth deducted the cash stock dividends paid to it by its subsidiaries. The Department restored this income, apportioned it as business income and made an additional assessment. Woolworth appealed the ruling to the Court of Appeals, which reversed the Department's ruling.

In examining the propriety of the Department's action, there are three basic questions: (1) whether dividends from Woolworth's foreign subsidiaries are "business income" under Section 7-4-2(A), N.M.S.A. 1978 and are thus properly apportioned and assessed by the Department, or whether the dividends are "nonbusiness income" and thus allocable only to the state in which Woolworth has its "commercial domicile"; (2) whether this state's allocation of the dividends from foreign subsidiaries violates Woolworth's right of due process, because of being taxation of income not earned in New Mexico; and (3) whether the Court of Appeals improperly shifted the burden of proof of certain factors relevant to these issues.

The Department cites the following evidence favorable to its position on these issues: Woolworth owns a majority or all of the stock in its subsidiaries, has the power of total control if it cares to exercise it, has an international vice president that is responsible for overseeing its foreign subsidiaries, has interlocking directors with some of the subsidiaries, includes the subsidiaries in its overall financing and planning and would be derelict in its obligations to its shareholders if it did not oversee the operations

of these companies. The managing directors of the subsidiaries are selected by Woolworth. The dividends paid are determined by Woolworth. There is a substantial exchange of business information, a teletype communication system and travel back and forth of executive personnel between the parent and its affiliates. Any substantial borrowing or other major decisions require approval of Woolworth. There is some flow back and forth of goods and financial resources. Management responsibilities are given to the foreign corporations only commensurate with the development of their abilities to act independently of the parent. In the past Woolworth has furnished investment capital and has made loans to its subsidiaries, but there were no debts outstanding at the time in question here. The dividends here were placed in Woolworth's general operating fund.

Woolworth introduced considerable evidence to support its contention that its foreign subsidiaries are independent of the parent and not part of a unitary enterprise and, therefore, the dividends received from them could not be constitutionally apportioned and assessed in New Mexico. We do not detail this evidence since we are considering the substantiality of evidence supporting the Department's decision, although all of the evidence has been assessed by the Court.

A. *Whether Stock Dividends of Woolworth's Foreign Subsidiaries Are Business Income.*

To overturn the Department's decision we must find that it is arbitrary, capricious or an abuse of discretion, not supported by substantial evidence or otherwise not in accordance with the law. § 7-1-25, N.M.S.A. 1978 (Repl. Pamp. 1979). Regrettably, it needs to be said that the State did a very poor job of inquiring into and developing the facts in this case.

Mr. William D. Dexter, General Counsel for the Multistate Tax Commission and the author of the amicus brief in this cause, has said:

> One of the most vexing problems facing the states and the business community in application of state income tax laws is the development of appropriate attribution rules for the taxation of income derived from intangible property interests by multistate-multinational corporations and their intertwined, affiliated and subsidiary corporations. (Footnote omitted.)

Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 Vand.L.Rev. 401, 401 (1976).

A bit of history is appropriate to an understanding of the New Mexico statutory scheme for dealing with this problem. In recent years, the case law on the tests to determine apportionability within a given state of foreign or out-of-state income of multinational or multistate corporations has been developing along two parallel lines. Before the promulgation of the Uniform Division of Income for Tax Purposes Act (UDITPA), the "unitary business" concept was developed to meet the due process challenge. This principle calls for a determination as to whether a number of business operations having common ownership constitute a single or unitary business or several separate businesses for tax purposes and it depends upon whether they are of mutual benefit to one another and each operation is dependent on or contributory to others. *Great Lakes Pipe Line Co. v. Commissioner of Taxation*, 272 Minn. 403, 138 N.W.2d 612 (1965). The cases hold that, in order to meet due process constraints, there must be some minimal connection between the interstate business activities generating the income and the states seeking to tax that income. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

The other line of cases looks at UDITPA and the rules passed in conjunction therewith and attempts to answer

the questions by a literal reading of the statutes and rules. UDITPA was promulgated by the Conference of Commissioners on Uniform State Laws in 1957 in response to the apportionment problem. 7A Uniform L. Ann. 91 (1978). New Mexico adopted the Uniform Act in 1965. 1965 N.M. Laws, ch. 203, codified in §§ 7-4-1 to 21, N.M.S.A. 1978. In 1967 the New Mexico Legislature enacted the Multistate Tax Compact. 1967 N.M. Laws, ch. 56, codified in §§ 7-5-1 to 7, N.M.S.A. 1978. The stated purposes of this legislation are to facilitate determination of the tax liability of multistate taxpayers, promote uniformity and convenience and avoid duplicative taxation. § 7-5-1, N.M.S.A. 1978. The Multistate Tax Commission in 1973 recommended regulations to be used in attributing corporate income among the states under UDITPA and these regulations were later adopted in New Mexico. N.M. Inc. Tax Regs.

The purpose here is to provide a system by which each state in which a multistate corporation does business can obtain its fair share of income taxes and no more. We read the statutes as calling for a method of allocation which is fairly calculated to assign to New Mexico that portion of the net income reasonably attributable to the business done in this state. *See Butler Bros. v. McColgan,* 315 U.S. 501 (1942).

Under UDITPA, all "business income" is apportioned to the state under a formula set forth in Section 7-4-10. Section 7-4-19 provides for equitable adjustment if the apportionment of taxable income does not fairly represent the extent of the taxpayer's business activity in the state. The figure resulting from the apportionment is then assessed for taxation by the state. "Nonbusiness income", is generally allocable to the "commercial domicile" of the taxpayer under the Act. § 7-4-5.

Thus the determination of whether the dividends received by Woolworth from its foreign subsidiaries are "business income" under UDITPA is crucial. The advan-

tage to Woolworth if it prevailed nationwide on its claim that gross-up and dividends from stock in foreign subsidiaries are deductible from gross income, as being nonbusiness income, is quite obvious, considering that this income would be apportionable only to the state of the corporation's commercial domicile, New York, where no income taxes are charged. Nationwide, Woolworth would get a tax windfall on $65,000,000 of income for this tax period.

UDITPA defines "business income" and "nonbusiness income" as follows:

> A. "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;
>
> . . . .
>
> D. "nonbusiness income" means all income other than business income;

§ 7-4-2, N.M.S.A. 1978.

N.M. Inc. Tax Regulation 17(a) expounds on the meaning of "business income":

> In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income.
>
> . . . .
>
> . . . [T]he critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer which are dependent upon or contribute to

> the operation of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and constitute integral parts of, a trade or business.

N.M. Inc. Tax Regulation 17(b)(4) provides:

> Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations.

The Court of Appeals, in *Tipperary Corp. v. New Mexico Bur. of Rev.*, 93 N.M. 22, 595 P.2d 1212 (Ct. App. 1979), *cert. denied*, 92 N.M. 675, 593 P.2d 1078 (1979), analyzed Section 7-4-2(A), N.M.S.A. 1978, and divided the definition of business income into two parts: (1) transactions and activity in the regular course of a taxpayer's trade or business, and (2) situations where acquisition, management and disposition of property constitute integral parts of the taxpayer's regular trade or business operations, citing *McVean & Barlow, Inc. v. New Mexico Bureau of Rev.*, 88 N.M. 521, 543 P.2d 489 (Ct. App. 1975), *cert. denied*, 89 N.M. 6, 546 P.2d 71 (1975). The Court then decided *Tipperary* on the first part of the definition, ruling that the evidence showed that a sale of oil and gas leases was an activity in the regular course of Tipperary's business. Dexter, *supra*, 29 Vand.L.Rev. 401 (1976), calls the first prong a "transactional test" and the second prong a "functional or use test".

In *Tipperary*, the Court also adopted from Judge Wood's concurring opinion in *Champion, supra*, a three-prong test to determine whether income arises from transactions in the regular course of business: (1) the nature of the par-

ticular transaction, (2) former practices of the business entity, and (3) how the income is used. *See Qualls v. Montgomery Ward & Co. Inc.*, 266 Ark. 207, 585 S.W.2d 18 (1979); *Sperry and Hutchinson Co. v. Department of Revenue*, 270 Or. 329, 527 P.2d 729 (1974); *Great Lakes, supra.* We hold that there is substantial evidence here to meet all the tests required in *Tipperary.* The income arose from activities of Woolworth in the regular course of its business. The income was acquired and managed as an integral part of its regular business operations. § 7-4-2(A). The purpose for acquiring and holding the stock is related to its business operations. N.M. Ind. Tax Regulation 17(a). The three-prong *Tipperary* test of Judge Wood is fully met by the evidence in favor of apportionability.

B. *Constitutionality of Including the Dividends as Business Income.*

Having determined that the dividends are "business income" apportionable under the New Mexico statutes, we now must examine whether the State's assertion of apportionability is constitutional.

The United States Supreme Court, in the case of *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), decided after the Court of Appeals' decision in our case, has answered a number of our questions.

In *Mobil* the Commissioner of Taxes in Vermont ruled that dividend income from Mobil's foreign subsidiaries and affiliates should be included in the tax base. Mobil claimed that this action unconstitutionally subjected the corporation to multiple taxation. The Supreme Court of Vermont found a sufficient nexus between the corporation and the State of Vermont to justify an apportioned tax on the dividends. The United States Supreme Court affirmed the decision, holding that the tax does not violate the due process clause or the commerce clause and does not impose a burden on foreign commerce.

The Court in *Mobil* recognized some general principles:

> It long has been established that the income of a business operating in interstate commerce is not immune from fairly apportioned state taxation. (Citations omitted.) "[T]he entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S., at 460. For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a "minimal connection" between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise. (Citations omitted.) The requisite "nexus" is supplied if the corporation avails itself of the "substantial privilege of carrying on business" within the State; and "[t]he fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444-445 (1940).

Id. at 436-37.

Mobil, however, contended that "its *dividend* income must be excepted from the general principle of apportionability because it lacks a satisfactory nexus" with Mobil's business activities in Vermont. *Id.* at 437. But the Court ruled that the foreign source of the income would not preclude its taxability so long as the intrastate and extra-state activities formed part of a single unitary business. *See also Exxon Corp. v. Wisconsin Dept. of Revenue*, —— U.S. ——, 100 S.Ct. 2109 (1980); *Butler Bros., supra.* The Court stated that separate accounting may fail to account for contributions to income resulting from functional integra-

tion, centralization of management, and economies of scale. These factors of profitability arise from the operation of the business as a whole and "it becomes misleading to characterize the income of the business as having a single identifiable 'source'." *Supra* at 438.

The Court further stated:

> [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle. In accord with this principle, what apellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. *Bass, Ratcliff & Gretton* [266 U.S. 171] forecloses the contention that the foreign source of the dividend income alone suffices for this purpose.
>
> . . . .
>
> Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits derived from a *functionally integrated* enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.
>
> Superficially, *intercorporate division* might appear to be a more *attractive basis for limiting apportionability.* But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements

> for apportionability. Cf. *General Motors Corp. v. Washington*, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.
>
> . . . Where the business activities of the dividend payor have nothing to do with the activities of the recipient . . ., due process considerations might well preclude apportionability, because there would be no underlying unitary business. (Emphasis added and footnotes omitted.)

Id. at 439-42.

The Court was similarly unpersuaded by Mobil's contention that the Vermont tax imposes a burden on foreign commerce, reasoning that this argument attempted to focus attention on the effect of foreign taxation when the effect of domestic taxation is the real issue. The Court held that the only inquiry of constitutional dimension is "the familiar question whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation." *Id.* at 447. The Court ruled that Mobil had failed to demonstrate any sound basis, under either the due process clause or the commerce clause, for establishing a constitutional preference for allocation of its foreign source income to the state of commercial domicile. *See Exxon, supra.* The Court distinguished *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), relied on by Woolworth here.

Thus, under *Mobil*, the key question in determining the constitutionality of the allocation of Woolworth's dividends from foreign subsidiaries as apportionable "business income", is whether those dividends were income earned in a unitary business.

Our Court of Appeals has previously addressed this issue in *Champion, supra,* where the income in question was from renting an unneeded portion of its office building, short-term investments of operating capital and profit from the sale of timber. Champion claimed that the income was not part of its multistate unitary business. The Court of Appeals held that the income was business income since it was obtained from normal and customary practices of the corporation, and stated:

> A multi-state business is a "unitary business" for income tax purposes when operations conducted in one state benefit and are in turn benefited by operations in another state. [Citing *Great Lakes, supra.*] "If its various parts are interdependent and of mutual benefit so as to form one integral business rather than several business entities, it is unitary." *Webb Resources, Inc. v. McCoy,* 194 Kan. 758, 766, 401 P.2d 879, 886 (1965).

Id. at 413, 540 P.2d at 1302.

Generally, "unitary business" means a business, "the component parts of which are too closely connected and necessary to each other to justify division or separate consideration as independent units." *Maxwell v. Kent-Coffey Manufacturing Co.,* 204 N.C. 365, 168 S.E. 397, 399 (1933), *aff'd without opinion,* 291 U.S. 642 (1934); *see Butler Bros., supra; Great Lakes, supra.*

Woolworth's investments in its foreign subsidiaries exceeded those of the parent corporation. The possession of large assets by subsidiaries is a business advantage of great value to the parent; "it may give credit which will result in more economical business methods; it may give a standing which shall facilitate purchases; it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige." *Flint v. Stone Tracy Co.,* 220 U.S. 107, 166 (1911); *see Montgomery*

Ward & Co. Inc. v. Commissioner of Taxation, 276 Minn. 479, 151 N.W.2d 294 (1967); *Great Lakes, supra.*

The Supreme Court of New Jersey has considered the precise question as here and concluded that Woolworth's is a unitary business and that its foreign dividends are business income. *F. W. Woolworth Co. v. Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965).

On the due process issue and in conformity with *Mobil*, we hold that, for income tax considerations, there is substantial evidence in this record that Woolworth was conducting a unitary business with its foreign subsidiaries and that there is a sufficient nexus between the corporation and the State of New Mexico to justify an apportioned tax on these dividends. The income is obviously related to the mutual activities of the parent and its affiliates. The control over the subsidiaries, the interdependence, the history of the relationships, the placing of the money in the general operating account, all point to functional integration and reveal an underlying unitary business for our purposes here. We reverse the Court of Appeals on this point. *Mobil, supra; Am. Smelting & Refining v. Idaho St. Tax Com'n*, 99 Idaho 924, 592 P.2d 39 (1979).

Woolworth's claims as to violations of the commerce clause have no validity and are fully answered in *Mobil.*

C. *Burden of Proof.*

The Department complains that the Court of Appeals erroneously shifted the burden of proof to the Department on the question of what use was made of the income from foreign dividends. The *use* is pertinent in determining whether there is a unitary business. *See Tipperary, supra; Sperry and Hutchinson Co. v. Department of Revenue, supra.* The Department found that the dividends were placed in Woolworth's general fund and used for general corporate operating expenses. But the Court of Appeals

stated that, since there was no evidence to conclude that the money was *used* for general corporate operating expenses, it was more reasonable to conclude that the money simply passed through the general treasury to the stockholders by way of dividends.

The Court of Appeals erred in so concluding. First, the burden was on Woolworth to demonstrate the uses made of the dividends. *See Tipperary, supra; Champion, supra.* This rule is based on the theory that the burden on an external agency of ascertaining the internal financial practices and procedures of a business is nearly insurmountable. *See General Motors v. Washington,* 377 U.S. 436 (1964); 29 Am.Jur.2d, *Evidence,* § 131 (1967). Also, once it was established that the dividend income had been deposited in the general corporate operating fund and no evidence as to its use was introduced, the Department's reasonable inferences are conclusive. *See Waldroop v. O'Cheskey,* 85 N.M. 736, 516 P.2d 1119 (Ct. App. 1973).

III. Apportionment

Woolworth claims that it was not given the full benefit of the factors in the apportionment formula, that this results in unfairness, and that the Department has statutory authority to correct inequities. The Court of Appeals never reached the issue of modification of the apportionment formula because of its holding that gross-up and dividends should not be included in Woolworth's tax base. After the hearing in this case, the Department did modify the formula to the extent of adding the foreign dividends and the foreign dividend gross-up amounts to Woolworth's sales factor denominator. Woolworth claims that this adjustment was not enough, but offered no evidence upon

which further adjustments could be predicated. The Department found that Woolworth failed to present "a reasonable and specific proposal" for further adjustments to Woolworth's payroll, sales and property factors and denied further modification to the formula.

"One who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed. (Citation omitted.)" *Butler Bros., supra* at 508. The taxpayer has the burden of establishing his exemption. *Norton Co. v. Dept. of Revenue,* 340 U.S. 534 (1951).

The burden of proving what modifications were necessary was definitely on Woolworth. *Donald M. Drake Company v. Department of Revenue,* 263 Or. 26, 500 P.2d 1041 (1972); *Deseret Pharm. Co., Inc. v. State Tax Comm.,* 579 P.2d 1322 (Utah 1978); *see* Dexter, *The Business Versus Nonbusiness Distinction Under the Uniform Division of Income for Tax Purposes Act,* 10 Urban Lawyer 243 (1978). Further, New Mexico courts have held and our statutes provide that any assessment of taxes is presumed to be correct. *Tipperary, supra; Champion, supra;* § 7-1-17, N.M. S.A. 1978 (Repl. Pamp. 1979).

There was nothing arbitrary or unreasonable about the Department's conclusion that dividend income is apportionable without modification of the formula. *See In Re Goodyear T. & R. Co., Corp. Income T., 1966, 1967, 1968,* 133 Vt. 132, 335 A.2d 310 (1975); *F. W. Woolworth Co. v. Commissioner of Taxes of State, supra.* Also, there being no substantial evidence upon which further adjustments may be predicated, we affirm the decision of the Department on this issue.

This case is reversed and judgment shall enter for the Department.

IT IS SO ORDERED.

/s/ MACK EASLEY
Mack Easley, Chief Justice

WE CONCUR:

/s/ DAN SOSA, JR.
Dan Sosa, Jr., Senior Justice

/s/ WILLIAM R. FEDERICI
William R. Federici, Justice

PAYNE, Justice

I must respectfully dissent and agree with the analysis of the Court of Appeals.

IN THE COURT OF APPEALS OF THE STATE OF NEW MEXICO

No. 3954

F. W. Woolworth Co., a New York corporation,
Appellant,

v.

Bureau of Revenue, State of New Mexico,
Appellee.

ADMINISTRATIVE APPEAL

[Filed, Court of Appeals of New Mexico, Dec. 4, 1979,
Hazel M. Davis, Clerk]

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OPINION

Walters, Judge

The Taxation and Revenue Department assessed additional corporate income taxes for taxpayer's fiscal 1976-77 year, and the taxpayer appeals. Woolworth contends that the Department's inclusion in Woolworth's base income of dividends paid to the parent company by foreign subsidiaries and foreign dividend "gross-up" amounts was unauthorized under New Mexico tax statutes. Those amounts, it says, do not constitute taxable business income under § 7-4-2A, N.M.S.A. 1978, and are not apportionable under

the Uniform Division of Income for Tax Purposes Act, "UDITPA" (§ 7-4-1 through 7-4-21, N.M.S.A. 1978).

The resolution of the appeal lies in determining whether either item, gross-up or foreign dividends, is business income. Only if both categories fit the description of "business income" may they be assessed for state tax purposes.

The statutory definition of business income was discussed in *Champion Int'l Corp. v. Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App.), *cert. den.* 89 N.M. 5, 546 P.2d 70 (1975), and recently in *Tipperary Corp. v. New Mexico Bureau of Revenue*, 93 N.M. 22, 595 P.2d 1212 (Ct. App.), *cert. den.* 92 N.M. 675, 593 P.2d 1078 (1979). Section 7-4-2A requires a supportable finding, to classify income as "business income," that the income arose (1) from transactions and activity in the regular course of the taxpayer's trade or business, or (2) from situations where the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

In a special concurrence in *Champion, supra*, Chief Judge Wood said:

> Pertinent in determining whether income arises from transactions in the regular course of business is "the nature of the particular transaction" and "former practices" of the business entity. [Citation omitted] Also pertinent is how the income is used. [Citation omitted.]

Taxpayer is a corporation having its principal place of business in New York. It receives dividend income from four foreign subsidiaries. "Gross-up" is the term applied to foreign taxes paid by the foreign subsidiaries which under Internal Revenue Code § 78 taxpayer is "deemed" to receive, and is reportable as dividend income if the taxpayer elects to claim a foreign tax credit on its federal return as permitted by Internal Revenue Code § 902.

1. Inclusion of gross-up as New Mexico business income.

The State urges that taxpayer must include gross-up in its apportionable New Mexico base income because the state income tax forms prescribed by the Director of the Department of Revenue and Taxation instruct the taxpayer to report "Federal Taxable Income as shown on Federal Form 1120, Line 30 . . ." and because § 7-2-2(S) defines base income as "federal taxable income and upon which the federal income tax is calculated."

Line 30 of the federal tax return is not exclusively determinative of what is federal taxable income. *Getty Oil Company v. Taxation and Revenue Dept.*, No. 3723 (Ct.App.), filed October 18, 1979. The gross-up figure included as dividend income in the federal return is reported only because the foreign taxes paid from those "deemed" dividends are later allowed to be deducted as a credit in computing taxes payable to the federal government. If the foreign tax credit were not claimed, the gross-up would not be "deemed" income and would not be reportable.

The definition of § 7-2-2(S) contended for by the Department ignores the portion of subsection (S) referring to the amount "upon which the tax is calculated." The calculation of federal tax does not rest solely on the amount shown at Line 30 of Form 1120; it is *calculated* upon that figure *less* certain credits shown at lines 10(a), (b) and (c), and *plus* other amounts shown at lines 13, 14, 15, and 16, all in Schedule "J" of the federal return. The foreign tax credit, which is not reflected in Line 30, is one of the amounts affecting calculation of the federal income tax.

The rigid insistence of the Department which requires the taxpayer to use only the Line 30 figure in reporting New Mexico income is a refusal to recognize an obviously fictitious income figure, made artificial by the federal reporting requirements for a specific purpose, and denies the taxpayer the right to show the true federal taxable income

"no matter where . . . [it] might be found in its consolidated federal return." *Getty, supra.* "That which is not in fact the taxpayer's income cannot be made such by calling it income." *Hoeper v. Tax Commission of Wisconsin,* 284 U.S. 206, 215, 76 L.Ed. 248, 56 S.Ct. 120 (1931).

"Gross-up" in fact represents income to taxpayer's foreign subsidiaries which is paid out in taxes to foreign governments. The record does not support the decision of the Director of the Revenue Division that the foreign subsidiaries use "a part of the taxpayer's dividends to pay taxes on behalf of the parent." The taxes paid are from income of the subsidiaries on behalf of the subsidiaries. "Gross-up" is not in fact dividend income to the taxpayer; ergo, it cannot be classified as "business" income, and it need not be included in taxpayer's New Mexico tax return. Sections 7-4-2A, D; N.M.S.A. 1978. *See F. W. Woolworth Co. v. Comm'r of Taxes,* 133 Vt. 93, 328 A.2d 402, 407 (Larrow, J. dissenting).

2. Inclusion of dividends from foreign subsidiaries.

The department also determined that $39,881,161 received by taxpayer in actual cash dividends from its foreign subsidiaries and excluded by the taxpayer from apportionable income subject to New Mexico tax, were derived from "an integral part of the corporation's operations." As such, they were assessed as business income, and a portion of the total amount was allocated as New Mexico's apportionable share for taxpayer's New Mexico operations.

Woolworth contends that its domestic operations constitute a unitary business of which the foreign subsidiaries are no part, and to which the foreign activities contribute nothing in the production of domestic income. Paragraphs 6 through 15 of the Department's Decision and Order support taxpayer's argument that unity of business operation among the domestic parent and the foreign subsidiaries is missing. The Department agrees that taxpayer operates a

unitary business in the United States, phrasing the argument on the question of foreign dividends as taxable business income in this fashion:

> The issue is whether the dividend income of a concededly unitary domestic corporation from substantial investment in its foreign subsidiaries is business income to be apportioned along with all other business income of the unitary business.

The Department relies in part on Paragraph 16 of the Director's decision which recites that the dividends are "placed in the general funds of the taxpayer and used for general corporate operating expenses." This reliance goes, of course, to the pertinency of use in determining whether such income was business income. *See Champion*, 88 N.M. at 418; *Tipperary, supra*, 595 P.2d at 1218. The evidence does support a finding that the dividends were deposited to taxpayer's general treasury; there is no evidence that the money was used for "general corporate operating expenses." As appellant taxpayer points out, the total cash dividends under discussion amounted to $39,881,161. During the same tax year, Woolworth paid out $39,986,308 in dividends to its United States shareholders. It is more reasonable to regard the dividend income as merely passing through the general treasury to stockholders than to declare, without any evidence in support, that it is used for operating expenses of the corporation.

Turning to the "regular course of business" analysis set out by Judge Wood in the *Champion* special concurrence, we note that the taxpayer's initial and only investment in the English subsidiary was $64,000 in 1911. When the German facilities were demolished during World War II, taxpayer contributed $400,000 to its rebuilding. The Mexican and Candian corporations are wholly owned subsidiaries. None of them are presently in debt to the parent company, and all of the subsidiaries have grown on their

own reinvestments. The dividend income from the foreign corporations is declared by the taxpayer as income to the parent allocable only to the state of domicile, New York, since the taxpayer contends that it is non-business income. Sections 7-4-2A, D, N.M.S.A. 1978.

The facts here are close to those of *Sperry & Hutchinson Co. v. Department of Revenue*, 527 P.2d 729 (Or. 1974). Like Woolworth, Sperry & Hutchinson (S & H) did business in forty-eight states and was domiciled in New York. Its primary and only business in Oregon was sale of a trading stamp promotional service to retailers. From its revenues, S & H invested in short-term securities held to satisfy its need for liquid capital in the stamp business; short-term securities held pending acquisition of other companies or favorable development in the long-term money market, and long-term securities held as an investment. The Oregon Supreme Court ruled, under a statute virtually identical to § 7-4-2A, N.M.S.A. 1978, that only the short-term investments which provided capital needed to meet business obligations during periods of cash flow deficits constituted "business income 'arising from transactions and activity in the regular course of the taxpayer's trade or business' . . . ." (527 P.2d at 731.)

The other investments, it said, were "not apportionable to Oregon because neither the capital invested nor the income derived therefrom are a part of the . . . business conducted in this state," and there was no showing that the interest on those investments was held for use in its Oregon business. That is also the state of the record presently before this court. There is no indication that the income from Woolworth's long-standing investments was used either in taxpayer's unitary domestic business or in its business conducted in New Mexico, *Champion, supra* (Wood, C.J.); *Sperry & Hutchinson v. Bureau of Revenue, supra.* Nor was there evidence (1) that the investments were "[b]usiness deals [or] the performance of a specific

function in the normal, typical, customary or accustomed policy or procedure of the taxpayer's trade or business," *Champion, supra* (Sutin, J.); (2) that the interest arose "from transactions in the regular course of [taxpayer's] business," *Champion, supra* (Wood, C.J.); (3) that there was any "relationship of the income source to the [regular] business activities of the taxpayer," *Tipperary, supra* (Lopez, J.); or (4) that investing in foreign corporations was "an integral part of the regular trade or business operations of taxpayer," *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue,* 88 N.M. 521, 524, 543 P.2d 489 (Ct.App. 1975).

Accordingly, we reverse the decision and order of the Department insofar as it includes those gross-up and dividend income amounts in taxpayer's 1976-77 taxable income.

IT IS SO ORDERED.

/s/ MARY C. WALTERS
Judge

WE CONCUR:

s/ Joe W. Wood, C. J.

s/ B. C. Hernandez, J.

BEFORE THE DIRECTOR OF THE REVENUE DIVISION OF THE TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO

In the Matter of the Liability of
F. W. Woolworth Company, I.D. No. 002154,
Under Assessment No. 224952.

Decision and Order

This matter came on for a hearing before John E. Owens on October 4, 1978 and was continued for the purpose of submitting briefs. F. W. Woolworth Company was represented by Michael Bray, Esq. The Taxation and Revenue Department ("Department") was represented by Richard M. Kopel, Esq.

On the basis of all the evidence presented, it is decided and ordered that:

1. This is a corporate income tax matter. F. W. Woolworth Company (herein called "taxpayer" or "parent") is a corporation with its headquarters in New York City. In its federal income tax return the taxpayer showed (a) a total amount of dividends from foreign corporations and (b) an amount for "foreign dividend gross-up". These two items totaled over 65 million dollars. On its New Mexico income tax return the taxpayer treated this total as non-business income and allocated the income to New York, the taxpayer's commercial domicile. The then Bureau of Revenue concluded that this amount should be treated as business income to be apportioned as provided in the Income Tax Act.

Gross-up and Withheld Taxes

2. When a United States parent corporation receives dividends from a foreign subsidiary corporation and the re-

cipient chooses the benefits of the foreign tax credit provided by the Internal Revenue Code, the recipient is "deemed" to have paid a portion of the foreign income tax paid by the foreign corporation that relates to the foreign source dividends. Income Tax Regulations § 1.902.1. The taxes "deemed" to be paid by the United States parent shall be treated as a dividend received by the United States parent. I.T. Reg. § 1.78-1. Thus, the deemed to be paid foreign tax is treated as dividends received and added to the United States parent's gross income. This is called gross-up.

3. It has been specifically held that "gross-up" is income for state income tax purposes. *F. W. Woolworth Company v. Commissioner of Taxes,* 298 A.2d 839 (Vt. 1972); *F. W. Woolworth Company v. Commissioner of Taxes,* 328 A.2d 402 (Vt. 1974). And other state courts have held that where a state tax statute defines income to mean federal tax income, taxable income for federal purposes is taxable income for state tax purposes. *Champion International Corporation v. Bureau of Revenue,* 88 N.M. 411 (1975); *Commonwealth of Pennsylvania v. Westinghouse Electric Corporation,* 386 A.2d 491 (1978), *app. dism.* —— U.S. ——, (Docket No. 78-138, October, 1978). Because under the Internal Revenue Code the "gross-up" amounts are treated as dividends received by the taxpayer and becomes part of the taxpayer's federal taxable income, the gross-up amounts must be included in the taxpayer's "base income" as defined in § 72-15A-2(S). See *Champion International Corporation v. Bureau of Revenue, supra.*

4. Part of the "dividends" shown in the taxpayer's federal return consisted of foreign withholding taxes. These relate to dividend payments made by the foreign subsidiaries. Foreign subsidiaries are often required to withhold foreign taxes on dividends paid. These taxes are withheld and paid by the foreign subsidiaries to foreign governments to satisfy the tax obligations of the parent. In this

role, the foreign subsidiary is using part of the taxpayer's dividends to pay taxes on behalf of the parent. These withheld foreign taxes are considered as dividend income to the parent and these withheld foreign taxes are included in the taxpayer's federal taxable income. The foreign withholding taxes must be treated as income for New Mexico income tax purposes.

Deductions

5. There is no provision in the New Mexico Income Tax Act which would permit this taxpayer to deduct any of these items of income in arriving at its New Mexico base income. In *Commonwealth of Pennsylvania v. Westinghouse Electric Corporation, supra*, the Court interpreted a statute similar to the New Mexico Income Tax Act and concluded that where a taxpayer has voluntarily elected to utilize the federal tax credit route, the taxpayer cannot tax a deduction for state tax purposes. The federal rule is the same. If a taxpayer claims the foreign tax credit, no portion of the foreign taxes may be taken as a deduction. I.T. Reg. § 1.901-1(c). For New Mexico income tax purposes the taxpayer is not entitled to deduct items of income which are not deductible for federal tax purposes.

Business or Non-business Income

6. The taxpayer is engaged throughout the United States in the business of selling general merchandise at retail. It purchases inventory items and sells them to the public through Woolworth and Woolco retail stores. The Woolworth stores sell a variety of consumer items including dry goods, hardware, small appliances, candy and some packaged food and some clothing items. Most, if not all, also serve fountain items and meals. Woolco stores are considered to be discount stores; they retail a broader range of items than do the Woolworth stores.

7. Over the years the taxpayer has acquired or established subsidiaries in the United States and in foreign countries. In particular, there are four foreign subsidiaries with which we are concerned.[1]

A. F. W. Woolworth Company, Ltd., is an English corporation, 52.7 percent of which is owned by the taxpayer. The balance of the stock is owned by the public. Its chief executive—called managing director—is an citizen of England and has held this position for a number of years. It sells, at retail, through 2,000 Woolworth and Woolco stores throughout the British Isles.

B. F. W. Woolworth, Gmbh, is German corporation, wholly owned by the taxpayer. It has two managing directors, both of whom are German nationals. It sells items at retail through Woolworth stores.

C. F. W. Woolworth, Ltd., is a Canadian corporation, wholly owned by the taxpayer. It's president is a Canadian. This subsidiary sells retail items through Woolworth and Woolco stores.

D. F. W. Woolworth, S.A. de C. V. Mexico, is a Mexican corporation, wholly owned by the taxpayer, and it operates in Mexico selling through 12 Woolworth stores.

8. Each of the four subsidiaries are responsible for determining the size and location of retail stores, the market conditions in their own territory and the mix of items to be sold. The German subsidiary emphasizes soft goods such as dresses and coats. It sells no food. The English subsidiary operates restaurants in its stores and also operates supermarkets. Each subsidiary attempts to cater to local tastes and needs. The inventory of each subsidiary consists, in large part, of home country produced items. This purchase-

[1] There are foreign subsidiaries and sub-subsidiaries owned by the taxpayer other than the four subsidiaries with which we are concerned.

at-home practice is consistent with the policy of the taxpayer. A number of inventory items are purchased from the Orient or other places but there is no evidence that the subsidiaries purchase, or are required to purchase, inventory items from any particular source.

9. The English and German companies handle their own advertising (there is very little advertising in Germany), and their own local accounting; each have policies on employees; and each have local outside counsel.

10. The taxpayer does not have a personnel training school for the foreign subsidiaries. In the taxable year involved, none of the four subsidiaries officers were currently or formerly employees of the parent. An officer in a Spain subsidiary and an officer of the Mexico subsidiary were also participants in the taxpayer's profit sharing plan and the taxpayer paid the employee's share of such plan.

11. The taxpayer has a large board of directors, approximately 15 persons. The managing director of the English subsidiary is on the taxpayer's board and the English subsidiary. The parent company sends an officer to participate in the English board of directors meetings. At least one person who is on the Canadian subsidiary is also on the taxpayer's board. At least one officer of the Canadian subsidiary is also an officer of the taxpayer.

12. Chief executives of the subsidiaries who are not on the taxpayer's board, are not in regular attendance at the taxpayer's board meetings. Such executives, or subordinate officials attend board meetings when the taxpayer wants them present. The taxpayer has no department or section, as such, devoted to overseeing the foreign subsidiary operations. The taxpayer's chief executive and other officers of the taxpayer visit the foreign subsidiary operations and vice versa. The taxpayer has a vice president who is the liaison man with the smaller foreign subsidiaries. There is frequent communication between the parent and the subsidiaries by mail, telephone or teletype.

13. The parent has the right to control the financial matters of the subsidiaries. Individual subsidiaries are responsible for the day-to-day financial matters but major decisions must be approved by the parent. The taxpayer determines the amount of dividends to be paid by the subsidiaries.

14. The parent's financial statements—e.g., annual report—are prepared on a consolidated basis which includes the parent and all wholly owned subsidiaries. The English subsidiary is not included in the consolidated statements.

15. The English subsidiary was established a number of years ago. The taxpayer paid $64,000 for its interest in the subsidiary. The parent may have loaned money to the subsidiary but if so, there is no outstanding debt. The German corporation facilities were, in effect, demolished during World War II and the subsidiary was revived after the War. The parent loaned or made a capital contribution of about $400,000 to this subsidiary after the war.

16. The four subsidiaries declared and paid dividends to the parent. Dividends received by the taxpayer from the four subsidiaries were placed in the general funds of the taxpayer and used for general corporate operating purposes.

17. This taxpayer was previously involved in similar state tax questions. In *F. W. Woolworth Company v. Director of Division of Taxation*, 213 A.2d 1 (1965), the New Jersey Supreme Court held that this taxpayer and its Canadian, Mexican, German and English subsidiaries were engaged in a unitary operation. *F. W. Woolworth v. Commissioner*, 298 A.2d 839, the Vermont Supreme Court in holding that "gross-up" dividends are subject to apportionment was holding *sub silento*, that the taxpayer and its subsidiaries were engaged in a unitary operation.

18. The evidence in this case shows that the foreign subsidiaries operated in a similar, if not an identical, fashion as did the parent: sales of similar products; use of the Woolworth and Woolco names; interlocking directors; com-

munication of business matters which concern both parent and subsidiary. In addition, the parent had fiscal and management control over the subsidiaries. Considering all the evidence, it is concluded that the income in question is business income, subject to apportionment.

Modifications to the Statutory Formula

19. The taxpayer alternatively claims that in this case there must be modifications to the three factor formula provided in UDITPA (§ 72-16A-34); specifically the taxpayer wants the foreign corporations' payroll, sales and property added to the denominator of the taxpayer's payroll, sales and property factor.

20. At least two states have considered the provisions of UDITPA and concluded that the three factor apportionment formula should be applied uniformly, and it is only in exceptional situations may the relief provisions in UDITPA be applied. *Donald M. Drake Company v. Department of Revenue*, 500 P.2d 1041 (1972); *Deseret Pharmaceutical Company, Inc. v. State Tax Commission*, 579 P.2d 1322 (Utah, 1978). And the party who seeks to deviate from the statutory formula and invoke the applicability of the relief provisions has the burden of proof. *Deseret Pharmaceutical Company, supra.*

The Department has added the "dividends" and the "foreign dividend gross-up" amounts to the taxpayer's sales factor denominator.[2] Increasing the taxpayer's denominator does result in a smaller sales factor. The taxpayer says this adjustment is not enough; but the taxpayer has not shown specifically what adjustments to the taxpayer's payroll, sales and property factor are proper and necessary to come up with an equitable result as envisioned in § 72-15A-34.

---

[2] Actually the so-called sales factor spoken of in § 72-16A-31 is in reality a gross receipts factor. "Sales" is defined in § 72-15A-17 as all gross receipts not allocated.

21. Taxpayer argues that the Department must use the three factors of the foreign subsidiaries but it fails to suggest that the Department might then also take into account the net income of the foreign subsidiaries. In fact, however, the Department is not attempting to impose a tax on the net income of the foreign subsidiaries; the New Mexico tax is on the business income of the taxpayer and the taxpayer fails to show how the foreign subsidiaries' factors relate to this taxpayer's business income.[3]

22. In its brief, the taxpayer "petitions" for a modification of the statutory three factor formula. Assuming *arguendo* that this petition is timely, the taxpayer has not presented a reasonable and specific proposal which would meet the requirements of § 72-15A-34.

23. The taxpayer's protest is denied.

Done this 2nd day of January, 1979, in Santa Fe, New Mexico.

ARTHUR B. SNEAD
Director, Revenue Division

By /s/ JOHN E. OWENS
John E. Owens
Hearing Examiner
Taxation and Revenue Department

---

[3] Although some courts have expressed views similar to those proposed by the taxpayer (e.g., see the *Woolworth* cases in New Jersey and Vermont, cited *supra*) it is doubtful that looking at the payroll, sales and property of one corporation (a foreign subsidiary) is appropriate in attempting to apportion income of a different corporation (the domestic parent). Short of taxing a parent on a "combined" basis, there seems to be no authority, under § 72-15A-34, to look beyond the payroll, property and sales of the particular taxpayer. This taxpayer has never suggested filing a report on a combined basis.

Certificate of Mailing

I hereby certify that a true copy of this Decision and Order was mailed to F. W. Woolworth Company, Executive Office, Woolworth Building, New York, New York 10007 and to Michael D. Bray, Esq., Armstrong & Bray, 20 Exchange Place, New York, New York 10005 all on this the 2nd day of January, 1979.

/s/ JOHN E. OWENS
John E. Owens

APPENDIX B

IN THE SUPREME COURT OF THE
STATE OF NEW MEXICO

Friday, January 30, 1981

No. 12,876

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, Petitioner,

vs.

F. W. WOOLWORTH COMPANY, a New York corporation, Respondent.

Original Proceeding on Certiorari

This matter having heretofore been submitted and taken under advisement, and an opinion of the Court having been handed down on January 19, 1981 and Judgment entered reversing the decision of the Court of Appeals, and no motion for rehearing having been filed;

NOW, THEREFORE, IT IS ORDERED that the Judgment entered herein on January 19, 1981, reversing the decision of the Court of Appeals be and the same is hereby made final, and the cause be and the same is hereby remanded with directions that Judgment be entered for the Department.

IT IS FURTHER ORDERED that the Record in Cause No. 3954 be and the same is hereby returned to the Clerk of the Court of Appeals.

ATTEST: A TRUE COPY

/s/ ROSE MARIE ANDRETE
Clerk of the Supreme Court of the State of New Mexico

IN THE COURT OF APPEALS OF THE
STATE OF NEW MEXICO

Administrative Appeal No. ——

No. 3954

F. W. Woolworth Co., Appellant

v.

Bureau of Revenue, Appellee

Mandate

(Applicable items are indicated by an "X" below.)

1. — Attached is a true and correct copy of the original decision entered in the above-entitled cause.

2. — This decision being now final, the cause is remanded to you for any further proceedings consistent with said decision.

3. X Writ of Certiorari having been issued by the New Mexico Supreme Court and their decision now being final, this cause is remanded to you for any further proceedings consistent with said Supreme Court decision attached hereto.

4. — You are directed to issue any commitment necessary for the execution of your judgment and sentence.

5. — Cost Bill is assessed as follows:

6. — District Court Clerk's Record returned herewith.

7. — Exhibits filed herein shall be picked up at this Clerk's Office forthwith.

By direction of and in the name of the Chief Judge of the Court of Appeals, this 6th day of February, 1981.

(SEAL)
CC: Counsel

/s/ SUSAN W. BAGWELL
Clerk of the Court of Appeals of
the State of New Mexico.

(Tear off and return this receipt)

No. 3954

RECEIPT IS ACKNOWLEDGED of the original mandate and Clerk's Record.

DATED: _____ _____
Clerk of the District Court

[ATTEST: A true copy. Susan W. Bagwell, Clerk of the Court of Appeals of the State of New Mexico.

By: /s/ VERA C. LOPEZ, Deputy]

APPENDIX C

IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

No. 12,876

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, Petitioner-Appellee,

vs.

F. W. WOOLWORTH Co., a New York Corporation, Respondent-Appellant.

Notice of Appeal
To the Supreme Court of the United States

[Court of Appeals of New Mexico, FILED, March 20, 1981, Susan W. Bagwell]

Notice is hereby given that F. W. WOOLWORTH COMPANY, the appellant above-named, hereby appeals to the Supreme Court of the United States from the final judgment of the Supreme Court of the State of New Mexico, entered in this proceeding on January 19, 1981, reversing the judgment of the Court of Appeals.

This appeal is taken pursuant to 28 U.S.C. 1257(2).

Dated: This 26th day of March, 1981.

/s/ JOHN P. DWYER

John P. Dwyer, Attorney for
Respondent-Appellant
1210 Bank of New Mexico Building
Albuquerque, New Mexico 87102
(505) 247 9586

APPENDIX D

New Mexico Statutes 1978, Annotated

7-2-2. Definitions.

* * * * * * * * * *

S. "base income" means that part of the taxpayer's income generally defined as federal taxable income and upon which the federal income tax is calculated;

T. "net income" means base income adjusted to exclude:

(1) amounts that have been taxed as income to another member of an affiliated group of corporations under the Banking and Financial Corporations Tax Act [7-6-1 to 7-6-9 NMSA 1978]; and

(2) amounts that the state is prohibited from taxing because of the laws or constitution of this state or the United States; and

* * * * * * * * * *

7-4-2. Definitions.

* * * * * * * * * *

A. "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;

* * * * * * * * * *

7-4-3. Allocation and apportionment of income in general.

Any taxpayer having income which is taxable both within and without this state, other than the rendering of purely personal services by an individual, and making the election to do so as provided in the Income Tax Act [7-2-1 to 7-2-22

N.M.S.A. 1978], shall allocate and apportion his net income as provided in the Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 N.M.S.A. 1978].

7-4-5. Allocation of certain nonbusiness income.

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 6 through 9 [7-4-6 to 7-4-9 N.M.S.A. 1978] of the Uniform Division of Income for Tax Purposes Act.

7-4-8. Allocation of interest and dividends.

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

7-4-10. Apportionment of business income.

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

7-4-11. Property factor for apportionment of business income.

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

APPENDIX E

Internal Revenue Code

SEC. 78. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a)(1) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

[Sec. 902(a)]

(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION—For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

APPENDIX F

1981 Opinion No. 15

IN THE SUPREME COURT OF THE STATE OF IDAHO

No. 12198

Boise term, January 1981

Filed: March 4, 1981

R. H. Young, Clerk

AMERICAN SMELTING & REFINING Co., Plaintiff-respondent,

v.

IDAHO STATE TAX COMMISSION, Defendant-appellant.

On remand from the United States Supreme Court.

Prior opinion and order of this Court are *reinstated.*

David Leroy, Attorney General; Theodore V. Spangler, Jr., Deputy Attorney General, for State Tax Commission, Boise, Idaho, for appellant.

Philip E. Peterson, Lewiston, Idaho, and George Beatty, of Lee, Toomey & Kent, Washington, D.C., for respondent American Smelting & Refining Co.

William D. Dexter, Olympia, Washington, for amicus curiae Multistate Tax Commission.

Tyrone Fahner, Attorney General of Illinois, Chicago, Illinois, for amicus curiae State of Illinois.

PER CURIAM:

The order of this Court in American Smelting & Refining Co. v. Idaho State Tax Commission, 99 Idaho 924, 592 P.2d

39 (1979), was vacated by the United States Supreme Court in ASARCO, Inc. v. Idaho State Tax Commission, 445 U.S. ——, 100 S.Ct. 1333 (1980), and remanded for further consideration in light of the decision of the United States Supreme Court in Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. ——, 100 S.Ct. 1223 (1980). The case having been rebriefed and reargued, it is the conclusion of this Court that our prior opinion and order are consistent with both *Mobil Oil* and the more recent decision in Exxon Corp. v. Wisconsin Dept. of Revenue, 445 U.S. ——, 100 S.Ct. 2109 (1980). The opinion and order in American Smelting & Refining Co. v. Idaho State Tax Commission, 99 Idaho 924, 592 P.2d 39 (1979), are hereby reinstated.

APPENDIX G

Statutory Treatment of "Section 78 Gross-up" in the 33 States Which Have Adopted the Federal Income Base

States	Gross-up Not Excluded Under Cols. 2, 3 or 4	Excludes § 78 Gross-up	Excludes All Dividend Income	Partial Exclusion of Dividend Income
Arizona		X*		
Colorado		X		
Connecticut		X		
Delaware		X		
Florida		X		
Georgia			X	
Hawaii		X		
Idaho	X			
Illinois		X		
Indiana	X			
Iowa	X			
Kansas	X			
Kentucky			X	
Maine		X		
Maryland		X		
Michigan		X		
Massachusetts			X	
Missouri	X			
Montana	X			
Nebraska	X			
New Jersey		X		
New Mexico	X			
New York		X		
North Carolina				X**
North Dakota	X			
Ohio		X		
Oklahoma	X			
Pennsylvania			X	
Rhode Island	X			
Tennessee				X
Vermont		X		
Virginia		X		
West Virginia			X	

* This result is reached by allowing a deduction for foreign tax credits, including "deemed paid" credits, unless all dividends from the subsidiary are deducted under other provisions.

Office - Supreme Court, U.S.
FILED
NOV 19 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-1745

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO.,
Appellant,

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,
Appellee.

Appeal from the Supreme Court of New Mexico

JOINT APPENDIX

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Counsel for Appellee

Appeal Docketed April 17, 1981

Probable Jurisdiction Noted October 5, 1981

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RELEVANT DOCKET ENTRIES

COURT OF APPEALS OF NEW MEXICO

Docket No. 3954

F. W. Woolworth Co., a New York corporation,
Appellant,

vs.

Bureau of Revenue, State of New Mexico,
Appellee.

Date—Proceedings
1979

Jan. 31—Complaint on Appeal

Mar. 2—Transcripts—3 vols—1 ea.

Apr. 16—Appellant's request for oral argument

16—Appellant's letter advising he will not be filing a Brief in Chief

20—Court accepts Memorandum referred to in above letter as B.C. A.B. due 30 days from today

May 18—Motion for Additional Time to file A.B. thru 6-7-79—Granted

June 7—Motion to extend time for filing Answer Brief—Granted thru 6-11-79

11—Appellee's Answer Brief W/Certificate of Service

11—Request for Oral Argument

21—Motion for extention of time R.B.—Granted thru 7-2-79

July 2—Appellant's Reply Brief W/Certificate of Service

Sept. 6—Oral Argument calendar mailed to counsel—set for 10-15-79

Oct. 14—OA vacated and reset for Oct. 22

22—Submission Order

Dec. 4—Opinion (R) Wa-W-Hz

20—Motion for extension of time for filing Motion for rehearing

20—Motion for Rehearing (DENIED)

1980

Jan. 10—Notice of Certiorari

11—Opinion mailed to U.S. Law Week and Bar Bull.

Feb. 8—Sp. Ct. Order granting certiorari

8—Writ of Certiorari

1981

Jan. 19—Opinion on Cert Reverse

Feb. 4—Final order of Sup Ct on 1/30/81

6—Mandate

Mar. 30—Notice of Appeal to the U.S. Supreme Court

SUPREME COURT OF NEW MEXICO

Docket No. 12876

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,
Petitioner,

vs.

F. W. WOOLWORTH COMPANY, a New York corporation,
Respondent.

Date—Proceedings

1980

January 9—Petition for Writ of Certiorari
Notice to Court of Appeals

14—Motion Multistate Tax Commission for Permission to file Amicus Curiae Brief in Support of Petition
Amicus Curiae Brief

February 8—Order granting Petition
Writ of Certiorari

March 11—Brief of Respondent Taxpayer

27—Motion to file Brief and Request for Oral Argument

April 10—Order granting motion to file brief; denying request for oral argument—4/25/ to file brief

25—Supplemental Brief of Petitioner

1981

January 19—Opinion (Easley/S-F—Payne dissenting) (no written dissent)
Order Reversing Court of Appeals with directions that Judgment be entered for the Department

30—Order making Order of January 19 final
Letter requesting publication of C.O.A. opinion

March 30—Notice of Appeal to US Supreme Court
Affidavit of Service

December 28, 1977

Commissioner
New Mexico Bureau of Revenue
P. O. Box 630
Santa Fe, New Mexico 87503

Re: F. W. Woolworth Co.—Assessment Protest
Fiscal Year Ended January 31, 1977
New Mexico Corporation Income Tax Return
I. D. No. 01-924756-00

Dear Sir:

We are in receipt of your assessment of December 9, 1977. You take exception to our exclusion of dividend income and non-business interest income from apportionable business income; under the theoretical presumption that all income-producing activities generate business income, unless proved otherwise. It is our Company's position that such income is non-business income not subject to apportionment, for the following reasons:

A) *Dividend Income*

All dividend income is received from foreign subsidiaries, which engage in business exclusively in foreign countries; and have no connection whatsoever with the State of New Mexico. These foreign subsidiaries are functionally and organizationally separate from and independent of the parent company's operation in the United States. They have their own management, and do their own purchasing from sources within their own country of operation. The foreign subsidiaries establish their own pricing, determine their own merchandise mix and marketing techniques; perform their own accounting, and do their own advertising.

The foreign subsidiaries in question are not a source of materials or inventory for the parent company;

nor do they serve as a market for the parent company's products. The activities of the parent company in New Mexico and the United States contribute nothing to the value of, or the income from the foreign subsidiaries; just as the activities of the foreign subsidiaries contribute nothing to the earnings from the parent company's business in the United States or New Mexico.

Dividend income from our foreign subsidiaries is in reality investment income eminating from what is, for all practical purposes, a passive investment. This unique nature of the parent company's relationship with our foreign subsidiaries was recognized by the U.S. Tax Court in *F. W. Woolworth Co. v. Commissioner of Internal Revenue,* (54 T.C. 118, June 15, 1970), and it applies with equal credence as the basis for allocating dividend income out of New Mexico due to its non-business nature.

B) *Non-Business Interest Income*

Allocated non-business income is entirely of an intercompany nature, and as such does not arise from, and is not in any way related to the regular business operations of the F. W. Woolworth Co. in New Mexico. Interest income in the amount of $1,183,625 has been included in apportionable income as it is related to our business activities.

It is important to note that, in auditing F. W. Woolworth Co.'s New Mexico Income Tax Returns for the calendar years 1968, 1969 and 1970, the Multi-State Tax Commission concurred in our exclusion of dividend income from income apportionable to New Mexico. In addition, under the provisions of the Uniform Division of Income for Tax Purposes Act, as adopted by New Mevico, dividends and interest are allocable to the corporation's commercial domicile, which is outside New Mexico.

We trust that the above explanation of dividend and interest income for the fiscal year ended January 31, 1977 will justify the exclusion of these items from apportionable business income.

Very truly yours,

F. W. Woolworth Co.

/s/ J. J. Feeley
J. J. Feeley
Tax Manager

IN THE COURT OF APPEALS OF THE STATE OF NEW MEXICO

F. W. Woolworth Co., a New York corporation,
Appellant,

vs.

Bureau of Revenue, State of New Mexico,
Appellee.

COMPLAINT ON APPEAL

[filed Jan. 31, 1979]

Comes Now F. W. Woolworth Co., a New York corporation, by and through its attorney and for its complaint on appeal states and alleges as follows:

1. This appeal is taken from the Decision and Order of the Commissioner of Revenue made "in the matter of the tax liability of F. W. Woolworth Co., Bureau of Revenue I. D. No. 002154 under Assessment No. 224952 for New Mexico income tax for the company's fiscal year ending January 31, 1977", pursuant to and in compliance with the Tax Administration Act, Sec. 7-1-25 N.M.S.A. 1978, a copy of which Decision and Order is attached hereto as Exhibit A and incorporated herein by reference as though set forth in detail.

2. The Decision and Order (Exhibit A) is arbitrary, capricious, and an abuse of discretion, is not supported by substantial evidence in the record and is not in accordance with law.

3. Arrangement has been made with the Commissioner or his delegate for the preparation of the necessary transcripts of the record on which this appeal depends, pursuant to and in accordance with Sec. 7-1-25B. of N.M.S.A. 1978.

WHEREFORE, F. W. Woolworth Co., a New York corporation, prays that this Court set aside the Decision and Order of the Commissioner of Revenue hereinabove described, and grant appellant its costs and expenses incurred in connection with this appeal.

/s/ JOHN P. DWYER
John P. Dwyer
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CERTIFICATE

I hereby certify that I caused a true copy of this Complaint on Appeal to be mailed to the Commissioner of Revenue, State of New Mexico, Capitol Building, Santa Fe, New Mexico 87501, this 30th day of January, 1979.

/s/ JOHN P. DWYER
John P. Dwyer

TRANSCRIPT OF PROCEEDINGS BEFORE THE DEPARTMENT OF TAXATION AND REVENUE

Revenue Division

[p. 41]

* * * * * * * * * * *

MR. OWENS: Thank you. Before Mr. Kopel gives his opening statement, I am—I recall the protest also spoke of interest income which you did not discuss. Is that an issue?

MR. BRAY: We would concede the interest income as being part of the regular trade of business of Woolworth. You are quite correct, I had noticed that when Mr. Kopel handed me that schedule. We would not make an issue of that at this time.

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[p. 43] [MR. KOPEL:] Is that an issue still or not?

MR. BRAY: Well, the foreign exchange gain is a consequence of hedging—a hedging transaction designed to protect the investment.

In England because of the fertility [sic] of the pound, that is, against the dollar, it seems to me that logically that it would follow the characterization of the dividend income.

MR. KOPEL: So, it is still at issue?

MR. BRAY: Yes. I will distinguish that from the interest.

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[p. 52]

John J. Feeley

was called as a witness by the protestant, and having been first duly sworn, testified upon his oath as follows, to-wit:

DIRECT EXAMINATION

BY MR. BRAY:

Q. Mr. Feeley, would you state your position with the company once again for the record?

A. Tax Manager for F. W. Woolworth.

Q. How long have you been with the company?
A. Ten years.

Q. In your position as Tax Manager are you required to become familiar with all aspects of the company's operations?
A. Yes, I have become generally familiar with the total operations of the company.

Q. Would you describe the operations, the nature of the business performed by the New York company, F. W. Woolworth Company?
A. Well, F. W. Woolworth Company is a retailer and doing business in all of the states and in Puerto Rico and the Virgin Islands and conducts business under the Woolworth name and under the name of Woolco Department Stores.

Q. Could you give us an idea of the essential management [p. 53] decisions that have to be made in a business of this sort to conduct a merchandising retail outlet operation?
A. Well, generally speaking the merchandising is an important aspect—a most important aspect—of our operations. The management has to be able to determine the type and quantity of merchandise to buy which they can reasonably anticipate the public will purchase, and in addition management must select sites and conduct a research and market studies and market surveys as to the probable profitable locations of the retail stores.

It has to be able to generate and decide upon the type of financing necessary to stop and equip the stores with merchandise and also the necessary fixtures and leasehold improvements.

It has to establish operating procedures and controls over cash and establish policies with regard to personnel and to representations made to the public.

It has to generate adequate accounting records to properly control business and importantly, of course, they must make the public aware of their operations by advertising and advertising geared to the country as a whole and also geared to the various sections of the country.

Q. Recently a well-known retailer, W. T. Grant, went into bankruptcy. Do you have any thoughts on what the principal reason for that was?

[p. 54] MR. KOPEL: Objection, Your Honor, I don't know that that has any relevancy on the issue before the administrative hearing with respect to taxes for this taxpayer. If he would lay a foundation——

MR. BRAY: I am merely attempting to show one of the important elements of a merchandising operation which was inadequately considered by the W. T. Grant—it is not an important thing——

MR. KOPEL: Well, unless counsel can show the witness' expert knowledge or intimate knowledge with respect to the W. T. Grant operation and what took place with respect to W. T. Grant and why this occurred, I would—I think that the testimony is improper and has nothing to do with this particular hearing here.

I don't think that the witness could even qualify for that. But I would be glad to listen to it.

MR. BRAY: I'll withdraw it. It's a matter of background, really.

Q. (Mr. Bray continuing.) Now, you mentioned merchandising next and site selection. What is involved in site selection? How were these stores—how were these locations selected and how was the ownership taken?

A. Well, the sites are selected based upon the probable traffic that will be passing a store or being in the neighborhood of a store or the community to be served.

[p. 55] It is based on the market studies and it is also based upon the cost of the store area and the number of—the cost per square foot of selling area. It has to be such that the management in opening a store there can presume that it would be given an estimated sale volume and the occupancy cost of that particular location would permit them to earn a reasonable profit on the investment.

Q. I believe you also mentioned advertising and cash control and inventory control?

A. These are essential, yes.

Q. Now, with respect to the English and German subsidiaries, who makes the decision for seeing to the merchandise, site selection, advertising and accounting control?

A. Each subsidiary performs these functions autonomously and independently of the parent company.

Q. Are you aware of any instances where prior to the selection of a store site by the management of either the foreign subsidiaries where approval of this site selection was submitted to management of the New York company?

A. No, I do not.

Q. Would you say that there is any difference in tastes among the buying public, buying publics of England and Germany, as compared to the U. S.?

A. Well, there definitely are different tastes and different products that are sold in the stores in those [p. 56] countries, and there is also a different type of store.

For example, in England, many of the Woolworth stores have a large restaurant and cafeteria and in addition they have food halls, supermarket type of floors or portions of the store.

[Q.] So, you are saying in England there is what we would call a supermarket that is called a food hall over there, and that is something done in England?

A. This is done in England, in the Woolworth stores in England, and it is not done in the United States.

Q. What about Germany, can you give me an idea of significant inventory items which are different?

A. The German stores' inventories are heavily weighed towards soft goods such as clothing, coats, dresses, and so on.

They have no, or virtually, no operations in selling food to the public. They have a different advertising, and incidentally, they do very, very little advertising—no national radio or newspaper advertising—is carried on.

Q. Sticking with the merchandise difference, are you aware of U. S. management participating in the English—the decision in England to retail a food hall supermarket type of operation or to advise soft goods in Germany?

A. No, they figure that their operations are independent, autonomous. Their operations are conducted by German nationals [p. 57] and English nationals. We don't rotate personnel or train personnel to operate stores in those countries. There is no exchange of personnel.

Q. Are there any inter-company sales of inventory?

A. None.

Q. Could you just give me a general idea of where the inventory is derived by the various subsidiaries?

A. A high percentage of the inventory purchases by the various subsidiaries are made within their own particular country.

In addition, imports are made from the Orient and various other locations around the globe. A very high percentage of the purchases of the English company and the German company and the Mexican company and the Canadian company are from their own national sources.

Q. With respect to either the national source or with respect to imports into Germany or England are there any coordinated buying functions?

For example, if the U. S. stores require an item from the Orient and similar items are required in the stores in Germany and England, is there a central buying office that is consulted for these purchases that are made to present a more massive buying function to the outside world?

A. Well, that would appear to be economically feasible but it hasn't worked out with respect to the Woolworth Company.

[p. 58] Our buyers go to their suppliers independently and at different times of the year to make their purchases. There is no coordination, there is no pooling of the parent company buying with the German companies buying or the English companies buying.

I suspect there may even be some competition in some places with the other, with our subsidiaries, in the buying of the product.

Q. Could you tell me about accounting? Is there a central accounting office that accounts for both the U. S. operations and the subsidiaries operations in England and Germany?

A. Each subsidiary has a complete accounting department and a financial staff.

Q. Now, you are the Tax Manager for Woolworth, do you review the German tax returns and the English tax returns and consult with them on decisions affecting taxes?

A. No, I do not. I do write to them from time to time requesting tax receipts necessary for establishing our United States foreign tax credit.

In that connection they may furnish me with copies or calculations of their income tax computations.

Q. What about advertising? You mentioned Germany does very little advertising. What about England?

A. England is completely autonomous in advertising [p. 59] and there is a very high degree of local advertising in England as opposed to the United States where we have

national or large regional programs. It's uncoordinated. They write their own copy and buy their own time et cetera.

Q. Turning to personnel, both at the store manager level, and the executive level, is there any management school? Is there any training program that is central to transmit the Woolworth idea of merchandising such as it may be to the foreign subsidiaries?

A. No. They proceed on their own with their own programs, either formal or informal. They develop their own managers and instruct them in their methods of operation.

Q. What about the Chief Executive of the English and German subsidiaries? Are these—could you give me their names and tell me whether or not they hold a position as an officer of the New York company?

A. The German company manager's name is Mr. Bruno Weiss. He is the managing director.

[Q.] Is he the chief operating officer?

A. Yes. At present under the German law there are required to be two managing directors. The second managing director is a Mr. Peter Ellegast.

Q. Are these two individuals German nationals?

A. They are German nationals.

Q. Are they an officer in the New York company as well [p. 60] as an officer of the German company?

A. No.

Q. What about England, who is the chief operating officer in England?

A. A Mr. Owen.

Q. And is he a national?

A. He is an English national.

Q. How long has he been the chief operating officer of the English company, do you know offhand?

A. At least ten years. I am sorry, I don't know how far back he goes.

Q. Are there any other officers of the English company who are officers of the New York company?
A. No. Mr. Owen is a member of the Board of Directors of the New York company.

Q. What percentage of stock does the New York company own in the English company?
A. Fifty-two point seven.

Q. Who owns the remaining shares?
A. It's traded on the London Stock Exchange. It's owned by the public.

Q. Now, Mr. Feeley, could you tell me how these companies got started, financially? Tell me first of all when the New York company was formed and then when the English company was formed and how the English company has been capitalized?
[p. 61] A. The present company was formed in December—do you want that?

Q. I think just the general——
A. I would say in 1911, I think.

Q. And the English company?
A. At approximately the same time.

Q. What would you say the English company is worth now, or how is it carried on the books? Can you give me an approximate valuation?
A. The book valuation is upwards of thirty million dollars.

Q. What about the fair market value as evidenced by the shares traded on the London Stock Exchange?
A. I don't have that figure for you. I can get it for you.

Q. You mentioned thirty million dollars as book value. How much of that represents investment by the New York company in the English company?

A. The initial investment was in the neighborhood of sixty-four thousand dollars in the 1900's.

Q. Is there a method of accounting which accounts for the fact that it is now carried as some thirty million dollars on the books?

A. Yes. It was initially carried on the books up to a certain point using the equity method of accounting, and [p. 62] from that point forward the equity method wasn't used until after the amount of thirty million dollars had been outstanding for some time as far as the bookkeeping treatment was concerned.

Q. Let me ask the question another way. How much of that thirty million dollars represents advances by the New York parent company to the English company?

A. Zero.

Q. Sixty or seventy——

A. Advances, you used the word advances?

Q. I am talking about the——

A. The initial seed capital was approximately sixty-four thousand dollars.

Q. That's the only amount that has been advanced by the New York company to this subsidiary of that thirty million dollars? The rest represents the reinvestment by itself?

A. The bulk of that represents reinvestment.

Q. What about the German company?

A. The reason I hesitate going on answering is that in the earlier years there may have been some advances that were repaid, but of the thirty million dollars that is now existing on the record, I would say that that is the result of bootstrapping.

Q. What about the German company? Do you recall approximately what the book value of that company is?

[p. 63] A. Well—I do not. I would have to refer to a schedule.

Q. Well, let me ask you this, would you say that the—essentially the same reasoning applies that is to say that the German company has primarily relied on its reinvestment of its own earnings and this value has carried on the books, either that or the fair market value, is derived substantially, principally, from the earning of the German company as opposed to the advances made by the U. S. company?

A. The German company was completely written off at the end of World War II, and began its reconstruction with a very modest advance from the parent company, which was probably repaid, and it continued to grow based upon the reinvestment of their earnings. Again, another example of bootstrapping.

Q. Now, I would like to without repeating every question if I may ask a summary question concerning the Canadian and the Mexican subsidiaries, we talked about decisions concerning merchandise mix, site selection, advertising, accounting, training of personnel, and of those items would you say that there is a similarity between the relationship of the U. S. parent to Canada as there is to the German and the English subsidiaries to the extent to which these things are decentralized?

A. Yes, there is a distinct similarity or philosophy involved in the ownership of these companies.

[p. 64] MR. BRAY: I have no further questions of the witness at this time, Mr. Owens.

MR. OWENS: Let's take a ten minute break.

(THEREUPON, the hearing was in recess.)

CROSS EXAMINATION

BY MR. KOPEL:

Q. Mr. Feeley, you stated that you have been with Woolworths about ten years, sir?

A. Yes.

Q. What did you do before you went to Woolworths, sir?
A. I was with the State of Illinois Department of Revenue.

Q. For how long?
A. For five years.

Q. Have you always been the tax manager with the F. W. Woolworth Company, sir, for the ten-year period?
A. I was Assistant Tax Manager and was promoted to Tax Manager.

Q. How long have you been the Tax Manager?
A. I would say five years.

Q. You don't sit on the Board of Directors of the F. W. Woolworth Company do you?
A. No.

Q. Do you see the minutes of the meetings of the Board [p. 65] of Directors?
A. Yes.

Q. You are privy to that information?
A. Yes.

Q. You testified that Woolworths is a retailer. Expand on that a little bit. What is the business of the Woolworth Company in the United States?
A. The business of buying merchandise, maintaining retail stores in which merchandise that has been purchased for resale is displayed.

Q. So, merchandise is purchased at wholesale and sold at retail?
A. It is purchased from suppliers at various levels, perhaps direct from the manufacturer, from jobbers, importers, et cetera.

Q. And what is sold through these stores? What kinds of merchandise are we talking about, sir? Give us a broad category if you can for us?
A. You can start—first of all there are various types of classes of stores depending on the size of the community.

Q. Let's talk about the Woolworth. Let's not talk about Woolco yet. Let's just talk about Woolworths.

Let me help you, for example, you have soft goods, do you not, clothing, and things of that nature, men and womens' clothing?

[p. 66] A. They have men and womens' underwear, shirts, dresses, socks.

Q. Appliances?

A. Small appliances.

Q. Pots and pans.

A. Pots and pans.

Q. Flowers, plants?

A. Yes, hardware and toasters.

Q. If I were to say it's like what we used to call when I was a youngster a dime-store type stuff, initially, Woolworth, United, Kresges—this is the type of thing that we are talking about?

A. Absolutely.

Q. You have a store downtown Santa Fe on the Plaza do you not?

A. Yes.

Q. Have you been in that store?

A. No, I haven't been out that way.

Q. Now, Woolco is the discount operation is it not?

A. Yes.

Q. Like K-Mart?

A. Yes.

Q. And the merchandise sold through Woolco, then, is a much broader range of merchandise is it not?

A. Yes.

[p. 67] Q. When was Woolco formed, the discount operation?

A. In 1962, I think.

Q. Now, the Canadian operation, do Woolworth and Woolco sell anything different? I am not talking now the individual items of merchandise that are tooled to the individual tastes for the Canadians or for the Mexicans or the Germans or the English, other than the food that you talked about, basically are the Canadian operations the same as the American operation, that you are buying materials at various levels and then reselling it retail?

A. That's right.

Q. Basically, the same kind of business, isn't it?

A. That's right, the same kind of business.

Q. Is that true in Mexico, too?

A. Yes.

Q. And England?

A. Yes.

Q. And in Germany?

A. Yes.

Q. Okay. Now, you indicated in your direct examination that some of the stores in England or in Germany—especially in England you have what is called a food hall, where they have food and there is a cafeteria in conjunction with whereas in Germany you don't have it?

A. That's right.

[p. 68] Q. Is it not true that food is sold out of the United States stores?

A. We have counters here.

Q. Yes, they have counters where they sell food do they not?

A. That's true.

Q. And they sell candies and they sell all kinds of food items do they not in the United States stores?

A. Yes, concentrating principally on items such as crackers, candies, cookies that nature as opposed to the general range of a supermarket where you have all—meats and canned goods.

Q. Does Woolworth operate in Canada under the Woolworth name, sir?

A. Yes.

Q. And in Mexico?

A. Yes.

Q. And in Germany?

A. Yes.

Q. And in England?

A. Yes.

Q. And is the Woolco name used in all four of the countries, also?

A. No.

Q. In England?

[p. 69] A. Yes.

Q. In Mexico?

A. No.

Q. In Canada?

A. Yes.

Q. In Germany?

A. No.

Q. So, you don't have a discount type of operation in Mexico and Germany as you say?

A. No.

Q. But you do have in England and in Canada?

A. Yes.

Q. Is it not true that many of the discount operations today do operate food operations in conjunction with the discount merchandise?

A. I believe that's true, yes.

Q. As a matter of fact, if I wanted to go downtown Santa Fe and eat my lunch at your F. W. Woolworth store I could get lunch there?

A. Absolutely.

Q. And I can get that lunch in many stores throughout the country in Woolworths and in England and in Canada can I not?

A. Yes.

Q. Let's talk about the Canadian operation for a minute if we can. That's owned a hundred percent by Woolworths? [p. 70] A. Correct.

Q. When I say Woolworths, that's the taxpayer.

A. Right.

Q. Okay. Who controls the Board of Directors of the Canadian operation? Who elects the Board of Directors?

A. It is elected by the taxpayer.

Q. Woolworths has all of the seats on the Board of Directors of the Canadian subsidiary does it not?

A. I am not sure that I know what you mean when you say all of the seats. Do you mean being a hundred percent stockholder it elects the Board of Directors?

Q. Yes, elects the Board of Directors, right?

A. Right.

Q. Are these members of the Board of Directors the same people who sit on the parent, Woolworth?

A. Some of them are.

Q. How large is the Board of Directors of Woolworths, the taxpayer, how many member Board is it?

A. I am embarrassed to say that I can't recall.

Q. Approximately, sir?
A. Excuse me a moment, may I consult with Mr. Bray?

Q. Sure.
A. It's a large number—I am sorry but——

Q. It is over twelve isn't it and under twenty? Something around fifteen or eighteen, something in that area?
[p. 71] A. Right.

Q. How large is the Board of Directors of the Canadian subsidiary?
A. It is my impression that it is considerably smaller, but I have never focused on that.

Q. How many members of the Board of Directors of the taxpayer, Woolworths, sit on the Canadian subsidiary Board?
A. At least one.

Q. At least one?
A. Yes.

Q. But they control the Board of Directors because they own one hundred percent of the stock?
A. Yes.

Q. How many stores do you have in Canada?
A. Approximately, I would say about five hundred.

Q. You would say approximately and if you don't know——
A. I don't know. I don't have that information at my fingertips.

Q. All right. The officers of the Canadian company are appointed by the Board of Directors of the parent company are they not?
A. Yes.

Q. And are they the same officers that are the officers of the taxpayer, Woolworths?
A. No.

[p. 72] Q. They are different officers?
A. Yes.

Q. Are there any officers who are officers of Woolworths that are officers of the Canadian company to your knowledge?
A. Yes, at least one.

Q. Is that the managing director of the company?
A. Yes, I believe it is.

Q. The Canadian financial statement is a consolidated statement filed with the parent is it not, Woolworths?
A. Yes.

Q. And has been since, what, since 1960 or so, is that your understanding?
A. It has been as long as I have been with Woolworths.

Q. That's ten years, you were there in '68?
A. Yes, I would say at least ten years prior.

Q. It is not true that it is a policy of Woolworths that the goods sold in its stores and those of the foreign subsidiaries should be purchased in the country in which the store is located insofar as that is possible?
A. It is the merchandising concept, yes.

Q. So, that it is just good business to attempt to buy Canadian merchandise from a Canadian source and Mexico merchandise from a Mexican source and German merchandise from a German source, and English merchandise from an English source?
A. It has proven to be good business for us, yes.

[p. 73] Q. Now, you testified on direct that you do buy from the Orient as most people do today because of the cost involved, but it is still the policy to attempt to buy from the country in which the store is located to the best of the manager's ability, is it not?
A. That's true.

Q. Since the Board of Directors of the Canadian subsidiary is elected by the taxpayer, Woolworth, it is a fair statement to say that they control the financing and the loans and the borrowings for that Canadian subsidiary?

A. Well, they have the right to control.

Q. Well, if the officer-manager of the Canadian sub wants to make a decision with respect to some of the things that you were talking about for Germany and England—we were talking about the type or quality of merchandise to buy, site selection, research, operating procedures, personnel, in the case of Canada that is much more closely controlled by Woolworths in New York is it not?

A. There is, in the initial stages of the development of the Canadian company, it was more closely controlled, but as the company has grown it has been able to stand on its own feet to a greater extent.

Q. When was that change positive, do you recall?

A. It has been a gradual change.

Q. So, as the company matured more and more leeway was [p. 74] given to make their own decisions, is what you are saying?

A. As they demonstrated the ability.

Q. But the major decision, for example, if the Canadian sub wanted to go out and borrow a million dollars it wouldn't do that without the approval of Woolworth, the taxpayer?

A. Well, the Canadian financial people have the right to finance their day-to-day operations and I doubt that they would be required to at the level of a million dollars to seek the permission of the parent company.

If there was really substantial borrowings going on, I am sure the Canadians before borrowing it would obtain permission of the parent company.

Q. Who provides the legal advice, service, to the Canadian subsidiary, if you know, sir?

A. I don't know. They have their own Canadian counsel.

Q. Is there a planning aspect to the overall management of the F. W. Woolworth Company, future planning for—a department or like that is what I am asking you?

A. There isn't a department in existence at the present time that has that defined function. But obviously there has been planning in the management of the company.

Q. That's under the control of the Board of Directors, then? Is there a Vice President for planning or to whom is that responsibility delegated to?

A. There are various aspects of the planning that are [p. 75] carried by various officers, but we don't have a planning department as such.

Q. Who handles the investments of Woolworths' funds that are a part of its cash flow at any particular time, sir?

A. In the event that we have a surplus cash fund, on a temporary basis, it will be invested in the regular course of business in short term bankers' acceptance——

Q. Commercial paper?

A. Commercial paper and treasury notes and things like that.

Q. And the Treasurer is responsible for that?

A. Right.

Q. Is that an on-going activity of the taxpayer at the present time?

A. Yes, they continue from time to time to do that. Yes, I would say that they try to keep the surplus funds invested.

Q. How does money flow from the Canadian subsidiary to the parent?

A. Dividends.

Q. Is that the only way?

A. That's the only way.

Q. What was the investment in the Canadian subsidiary, if you know?

A. It was seventy-five thousand dollars in stock plus [p. 76] three million one hundred twenty-five thousand dollars in paid-in capital.

Q. The parent loaned money to the Canadian subsidiary from time to time for getting on its feet?

A. In the initial stages of development I would believe that would be the case. I don't know that was the case.

Q. Well, you talked about advances with respect to England and Germany and I assume that when you say advances you mean loans do you not?

A. Yes.

Q. Okay. It's normal for a parent to loan money to its subs is it not in the normal course of business?

A. Yes.

Q. If a sub was going out and borrowing money it would consult with the parent first to see if it could borrow money from the parent before it went outside the corporation, would it not?

A. It would depend on many circumstances. Normally, I would think that substantial borrowing, an unusual amount, would necessitate the checking with the principal stockholders or the Board of Directors.

Q. Okay. Let's talk about the Mexican company. When did it commence operations, approximately?

A. In 1956—I am going to say in '56.

Q. That's a fairly small operation?

[p. 77] A. Yes, that's a small operation.

Q. Compared to the English, German, and Canadian?

A. Yes.

Q. How many stores, just roughly?

A. About twelve.

Q. Again, that's one hundred percent owned?
A. Yes.

Q. Rather than me going through all of these questions, of course I will talk about some of them, but are there any major differences between the operation of the Canadian subsidiary and the Mexican subsidiary by the parent?

Let me rephrase the question. I don't think I stated that clearly.

I have asked you a number of questions, Mr. Feeley, regarding the relationship between the Canadian subsidiary and the parent and how it operates.

Are there any differences, basic differences, with respect to the Mexican operation?
A. No, just smaller.

Q. Again, the parent nominates all of the Board of Directors and some of the directors of Woolworth, the taxpayer, sit on the Board of the Mexican subsidiary, do they not?
A. Yes.

Q. Is this a fair statement, the active management of the Mexican company is a general manager whose duties and [p. 78] functions are similar to those of a district manager in the United States operation. Is that a fair statement, sir?
A. It may have been in one point in time.

Q. Is it today?
A. I don't believe so today.

Q. Why not?
A. Again, the subsidiary has been doing business for quite some time and the people who are operating it are given greater leeway at this time.

Q. So, that there is local supervision of purchasing and advertising and there may be local financing is what you are saying?
A. Yes.

Q. Some of the things that you referred to with respect to Germany and England?

A. Yes.

Q. Apparently what you are saying, Mr. Feeley, is that it has been a management policy of the parent to attempt to delegate responsibility to the subsidiary management commensurate with their abilities to operate effectively and profitably in those countries, is that a fair statement?

A. Yes, it is implied that you can derive a policy from that statement.

Q. So, if the Mexican subsidiary decides it wants to expand on X Street or Y town after careful research or marketing [p. 79] analysis and costs and so forth, that's left up to them as long as, on paper at least, the proposal, proposition, presented to the Board is acceptable, is that what you are saying, Mr. Feeley?

A. Yes.

Q. And they are better able in Mexico City to make that decision than the Board of Directors of the taxpayer sitting in New York?

A. That's correct.

Q. Let's talk about the German operation, now. Again, that's call Woolworth or Woolco?

A. F. W. Woolworth Co., G.m.b.H.

Q. When did that operation begin, approximately?

A. It was prior to World War II.

Q. You testified that they wrote it off after the war?

A. Yes, and it started after the war.

Q. Started after the war?

A. Yes.

Q. You testified that there was money advanced. Let's talk about that for a moment—to the German operation—how much was advanced, then, do you have any idea?

A. I believe it was four hundred thousand dollars.

Q. When you say advanced, again, that is a loan?
A. That's true.

Q. At interest, I presume?
[p. 80] A. I am not certain.

MR. OWENS: Since when?

MR. KOPEL: This was since World War II, Mr. Owens.
Q. (Mr. Kopel continuing.) Do you want to take a moment, counsel?

MR. BRAY: I am just jogging his memory——
A. I am not certain——

Q. (Mr. Kopel continuing.) Of the four hundred thousand?
A. Whether the four hundred thousand was a loan or a contribution in capital.

Q. Okay. It was money flowing from the parent to the subsidiary?
A. Yes.

Q. Are you familiar with the books and records since this goes back a long time before you came into the company with respect to other financial transactions between the German subsidiary operation and the parent with respect to any loans or type of contributions of capital, sir?
A. I do know that the parent company has consistently reinvested the dividends, a portion of the dividends, received from the German subsidiary in the German company, and steadily built-up its investment in Germany at that time.

Q. Is there some legal requirement that it do so?
A. No.

Q. The German subsidiary is one hundred percent owned
[p. 81] is it not?
A. That's correct.

Q. I have a statement here and do you know if this is true or not, "Because of German tax laws dividends declared by the German companies are loaned back by Woolworth, evidenced by notes, and retained by those subsidiaries."

Do you have any knowledge of that statement, is that true or not?

A. I think——

Q. I am reading to you from the *F. W. Woolworth vs. Director of Taxation*, which is a New Jersey case. That's a statement in this particular case. It's 45 N.J. 466, a 1965 decision of the Supreme Court of New Jersey.

Do you have knowledge of that at all, sir?

A. It doesn't sound accurate to me.

Q. Okay. Maybe the law has been changed since this decision—after all that's thirteen years ago.

Let's talk about the Board of Directors of the German subsidiary. How many people on that Board, if you know? If you don't know tell us approximately?

A. I don't know. I don't know the organization. I don't believe they have a Board of Directors, as such.

Q. I see. How about the officers? You have mentioned that there are two managing——

A. That's right, the managing directors they call them.

[p. 82] Q. Who selects those managing directors?

A. The parent company, the taxpayer.

Q. We have been talking about dividends which is really the issue of all of this. Who determines when dividends will be issued and the amount of the dividends to be paid by the subsidiaries to the parent?

A. That's a determination made by force of the German tax law and it was more economical up until 1975, I believe.

The German tax laws were geared to providing extensive —for not over-heating their economy. Therefore, they provided a lower corporation income tax rate on those earnings when they were distributed to the shareholders than if those earnings were not distributed as if they were reinvested.

So, the amount of the dividends were virtually established or was determined on the basis of the profit of the company.

Q. But the company could still determine to reinvest and build up its investment? It didn't have to pay it out, so, who made that decision, then?

A. That is made by the managing director.

Q. In conjunction with whom?

A. In conjunction with the parent company.

Q. So, in point of fact and with respect to the Canadian and the Mexican subsidiary, the Board of Directors of both of those companies, make the decision as to dividends, obviously?

[p. 83] A. That's right.

Q. So, in point of fact, then, with respect to these three operations the actual dividends which are paid out by the subsidiaries are determined by the parent, is that true?

A. Yes.

Q. Where are the parent's Board of Directors meetings held?

A. In New York.

Q. That's where the home office is?

A. That's correct, yes.

Q. In New York, and meetings are held there?

A. Yes.

Q. Who attends those Board of Directors meetings other than the Board, itself, do other people come in at that time?

A. From time to time outsiders are invited or principal managing directors of the foreign subsidiaries.

Q. That was my question. Is it not true that the managing directors of the foreign subsidiaries attend the Board of Directors meetings of the parent?

A. Well, they may be invited. They do not regularly attend or they may be excused for a portion of the meeting.

Q. Let me ask the question another way, sir. Do managing directors of the foreign subsidiaries come to New York to meet with the parent on occasion?

A. On occasion they do.

[p. 84] Q. How often would you say, once a quarter?

A. No. I would say once a year. It would be on a rare occasion, once a year.

Q. Is there other methods of communication between the parties?

A. Of course.

Q. Telephone?

A. Yes.

Q. Correspondence?

A. Yes.

Q. Do you have direct lines to these subsidiaries?

A. No.

Q. Do you have a teletype?

A. Teletype.

Q. Teletype in your office and in their office for direct communication?

A. We have——

Q. Tele-prompter or tele-copier?

A. We have a teletype, which as I understand it is over the R.C.A. radio lines.

Q. Where messages can be typed back and forth?

A. Yes, typed and addressed to the various cable addresses.

Q. Back and forth?
A. Yes.

[p. 85] Q. Is there a policy of the parent that all of the managers of all of the operations get together periodically to discuss the overall Woolworth operations?
A. No.

Q. They never get together and talk together about where the company is going or what it is doing or where it should be tomorrow or in ten years from today? Planning for future programs or for future expansion?
A. There hasn't been that.

Q. How many officers does Woolworth have?
A. The parent company has I would guess fifteen officers.

Q. Do these officers travel from time to time to confer with the subsidiary managing directors in Canada and in Mexico and in England and in Germany?
A. The Chief Executive Officer would on occasion travel to Canada, England, or to Germany to confer with the managers there. The other officers may, but the President does on occasion. It is hard to discern any pattern of regular monthly visits or quarterly visits.

Q. Well, is it not true that when you have far-flung operations sometimes an exchange of information becomes difficult? One of the ways that competent management of large business entities today tends to become more profitable is to have a healthy exchange of information? That's a pretty broad statement, but that's true?
[p. 86] A. Yes.
Q. Then, you attempt in large companies such as Woolworth and Woolco to gain the benefit of knowledge from your subsidiaries——

The parent attempts to gain knowledge from the subsidiaries that it can use in its operations, does it not?

A. The parent company's personnel and the subsidiary personnel will exchange information from time to time.

Q. On a fairly regular basis won't they, or at least if they have innovative ideas?

A. Yes, I would hope so.

Q. So, even though as you have indicated the German operation is fairly independent, Mr. Feeley, with respect to many areas that you have cited to us——

A. Yes, sir.

Q. ——nevertheless that does not mean that there isn't an exchange of information between people who make those decisions in Germany and those who make those decisions in the United States, is that not correct?

A. That's true.

Q. That's one of the way, hopefully, the company will have more on the bottom line isn't it?

A. Yes.

Q. Apparently England and Germany are doing something correctly since their bottom line has been better, on your [p. 87] testimony, than the American market? Now, there are other factors, I recognize that, but obviously they are successful merchandisers and sellers of products to the public?

A. Yes.

Q. Because they are generating more income, as you have indicated, than is being generated from the American operation?

A. Yes.

Q. So, I would assume, then, that there must be a constant change of information——

There must be a definite exchange of information shall we say between the subs and the parent in all levels? I am talking about purchasing, accounting, planning, advertising, merchandising, expansion or retraction from markets,

personnel training, site selection—those things are exchanged are they not so that each operation can take the benefit of the other's experience in success?

A. The exchange of information contacts by the subsidiaries is made by the Chief Executive of the company. The Director of Purchases of the parent company does not confer with the Director of Purchasing of the Canadian company or of the German company.

Q. The Director of Purchases never goes to England or never goes to Germany and see what is going on there. Has he never traveled there?

A. Oh, I am sure that he has traveled through all of [p. 88] those countries for purchases. We do import some items from the continent and from the British Isles, and as a matter of courtesy visit, I am sure, visit the counterpart in the subsidiaries.

But for an on-going dialogue on marketing conditions or the availability of and the pricing of merchandise between the——

Q. I see. It is not a day-to-day type of thing and he isn't telling them what to sell a given item for, I didn't mean that at all.

I am talking about the bigger picture—the big picture I am talking about.

A. Where it would be a major change in the big picture the Chief Executive officer of the parent company and the subsidiary company would exchange the information.

Q. Is the German tax return consolidated with the parent's?

A. No.

Q. Is it a consolidated return?

A. No, we can't. It is not permitted.

Q. How about England?

A. No, no foreign countries.

Q. That's true, okay——

A. Foreign subsidiary, and even——

Q. Now, wait a minute—what about the Mexicans?
[p. 89] A. No.

Q. No foreign subsidiary is allowed to file in conjunction?
A. That's true. If you are thinking of contiguous——

Q. I withdraw the question. When the parent files an annual report each year, in that annual report it discusses the operations of the subsidiaries does it not?
A. Yes.

Q. And the complete knowledge of all of its other holdings that is evidenced by Taxpayer's Exhibit Number One, which extends over and beyond these years that we are talking about, is that not true? All of its operations are discussed in that annual report?
A. Yes, there are comments made about the entire operation.

Q. By the parent?
A. Yes.

Q. Now, the English subsidiary is a little bit different is ot [sic] in that there is public ownership?
A. That's true.

Q. And it isn't one hundred percent owned?
A. That's right.

Q. I believe you said fifty-two point seven?
A. Yes.

Q. And the other forty-seven point three is public [p. 90] owned, is that right?
A. That's right.

Q. And the stock is traded on the London Stock Exchange, is that correct?
A. Yes.

Q. Now, we have been talking about the German subsidiary. Other than the difference in the stock ownership, is the

English operation similar to the German operation with respect to independence and so forth? You talked about that.

A. Yes, they are independent. They are autonomous.

Q. How large is the English operation, approximately?

A. Approximately two thousand stores.

Q. Is that throughout the British Isles? Does that include Ireland and Wales and Scotland?

A. Yes, and the Barbados, Jamaica.

Q. How many directors sit on the English subsidiary Board of Directors of the parent, do you know.

How many directors of the parent sit on the English Board?

Let me rephrase that question. I'll do it again. How many directors of the parent sit on the English Board of Directors?

A. One.

Q. Who is that?

A. The President of the F. W. Woolworth.

[p. 91] Q. Is that a change from previously as far as you know? It used to be three according to my information?

A. I don't have knowledge of the three.

Q. The Board of Directors of the English company is controlled by the parent, is it not?

A. Well——

Q. Since it has fifty-two point seven percent, it has the majority voting power and it does control the Board of Directors does it not?

A. The Board of Directors is permitted to operate, sometimes, with the President.

In many instances, let me say this, let me rephrase it. In many instances a representative of the parent company

does not attend the meetings of the English Board, which I understand meets once a month.

It is only sporadically that the parent company is represented at the Board meetings.

Q. However, again, I ask the question, the parent owns fifty-two point seven percent of the voting stock, therefore the parent at least determines fifty-two point seven, or the majority, of the Board of Directors in the English, is that not correct?

A. That's true.

Q. So, in common parlance we say that the parent controls the Board of the English subsidiary, does it not, sir? [p. 92] A. I would say that it has the right to control.

Q. Well, the members they elect are beholding to the parent are they not since the parent owns fifty-two point seven?

A. They are beholding to the parent and to the other minority stockholders as well.

Q. Okay. How many members of the English Board of Directors are members of the parent Board of Directors?

A. One.

Q. That's the Chairman?

A. Chairman?

Q. Chairman of the English Board of Directors is the member of the parent Board of Directors, is he not?

A. That's true.

Q. How about the German Board—well, in Germany you said there is no Board of Directors?

A. That's true. That's my belief. I don't know the legal point other than the German company is a German G.m.b.H. and that's about the extent of my expertise except to say that comes short of an organization between a corporation and a partnership.

Q. Well, is there a control in management in a G.m.b.H.?
A. Yes, there is a managing director.

Q. Well, I know you mentioned that there were two managing directors?
A. Yes.

[p. 93] Q. Well, the members of the Canadian subsidiary Board of Directors, do any of them sit on the Board of the parent company?
A. Would you restate that?

Q. I will restate the question. Do members of the Canadian Board of Directors sit on the parent Board, also?
A. Yes.

Q. How many?
A. I would say at least three.

Q. How about the Mexican Board of Directors, do members of that Board sit on the parent Board, also?
A. I don't know. I have never seen minutes of the Mexican company's Board. I don't know whether that is because of their foreign type organization or what, I don't know. There is a Board, as such, in the Mexican type of corporation.

Q. Is the Chairman of the Board of the Canadian operation one of the members that sit on the Board?
A. Yes.

Q. If there is a Canadian Board it is logical to conclude——
A. I am sure there is on the Canadian Board, but you asked me about the Mexican.

Q. I know, all I am saying is on the Mexican Board, it is logical to conclude that the Chairman of the Mexican Board probably sits on the parent Board, too, doesn't he?
A. I don't know.

[p. 94] Q. I think I covered this question, but just to make sure, when we talked about the decision to issue dividends, that again, is a decision that is made in conjunction with the parent Board of Directors, is it not, with respect to the English subsidiary, just as it is with the Canadian or Mexican or German subsidiaries? Is that not true, sir?

A. The decision to declare the dividend or to pay the dividend in Germany——

Q. I am talking about the English subsidiary?

A. Oh, the English subsidiary?

Q. Yes?

A. The decision is made by the English Board.

Q. And the parent has some input does it not?

A. The parent company is a member of the English Board of Directors.

Q. Okay. According to your exhibit here, Taxpayer's Exhibit One, you have got a lot of companies.

MR. OWENS: Exhibit A.

Q. (Mr. Kopel continuing.) Taxpayer's Exhibit A, thank you.

Are any of these manufacturing concerns of these subsidiaries on that chart in front of you, sir? Present corporate structure. I am looking at your Exhibit A?

A. Yes, I have it.

Q. Does Woolworth own any subsidiaries that manufacture [p. 95] articles?

A. Yes, it does. Woolworth owns the Kinney Shoe Corporation which does manufacture shoes.

Q. Lewis Shoe Company, is that a manufacturing company?

A. The Lewis Shoe Company is a manufacturer of shoes, yes.

Q. Richman Brothers, is that a manufacturer of clothing?

A. It is.

Q. What is F.W.W. Company of Canada, what does that mean?

A. Let's see——

Q. I am looking at your Taxpayer's Exhibit B, the fourth item under source of interest income, the F.W.W. Company of Canada?

A. Yes, I see.

Q. Do you know what that means?

A. That's the Canadian subsidiary, obviously.

Q. What does F.W.W. stand for, do you know?

A. F. W. Woolworth.

Q. Oh, that's all, very simple. What is 340 Supply Company, what does that mean?

A. The 340 Supply Company is a wholesale dealer in Coca-Cola syrup in Pennsylvania.

Q. Okay. Now, does the Canadian subsidiary buy merchandise from some of the manufacturing subsidiaries that we just talked about?

[p. 96] That is, from Kinney Shoes, Lewis Shoes, and Richman Brothers and so forth?

A. I don't know.

Q. Does the Mexican subsidiary buy any of their products?

A. I don't know.

Q. Does the English subsidiary?

A. I don't know.

Q. Does the German?

A. I don't know.

Q. It's conceivable they do if the price is competitive is that not true?

A. It is inconceivable to me because of the autonomous operation of the company and the lack of coordination and other facets that they would.

Q. There is nothing to prevent the English manager from buying from the Kinney Shoe Company if he thinks he can get shoes at a better price there than on the open market someplace else, is there?

A. Not to my knowledge—nothing to prevent it.

Q. Nothing to prevent it, okay.

A. I don't know English law as it is and import restrictions.

Q. Well, you don't really know where they buy their merchandise do you?

A. No.

[p. 97] Q. Either the English or the German?

A. I do know that the English company's sales and purchases are virtually nil.

Q. And you have testified that the parent doesn't force the subsidiaries to buy somewhere? They are pretty much independent to buy where they wish?

A. Yes.

Q. Let me ask you this question. Do you know if the English company purchases any goods from the American Woolworth Stores?

A. No.

Q. You don't know or you don't know that they do?

A. They do not—do you mean as an agent or as a supplier?

Q. What if Woolworth wanted to sell some English goods to its stores, wouldn't Woolworth turn to its English sub and be a buyer for it in order to get this merchandise for the American stores, sounds logical?

A. They might turn to the English company for suggestions as to a source.

Q. They might even help them buy, wouldn't they?

A. How do you help someone buy?

Q. Well, you tell them where to go and you can tell them how to bargain and you can tell them what the going rate is and you can tell them what is the right time to buy and what [p. 98] is the wrong time based on close-outs and all kinds of information that to which the English operation would be privy and which the American company wouldn't which could benefit the American company, is that not a possibility?

A. It is a possibility, but it is remote in our case.

Q. I see. Okay. I would like to review my notes if I may——

You testified that the initial investment made by Woolworth made in the English company back in 1911 was sixty-four thousand dollars?

A. Yes.

Q. Do you have knowledge of other investments or loans made by the parent in the English company subsequent to that?

A. I don't have specific knowledge, but I know there were.

Q. Do you have any idea of the amount of the nature of those investments over the years?

A. There were investments which were repaid.

Q. Those were loans, then?

A. They were loans.

Q. How much were those loans? What did they amount to?

A. I would say they were in the hundreds of thousands.

Q. Millions?

A. No.

Q. Hundreds of thousands how often?

[p. 99] A. Not too frequently. I would have to go back and search the record.

Q. Are there any loans outstanding at the present time that you know of?

A. None.

Q. Do you know when the last loan was paid off?

A. No. Certainly, any loan would have to have been—I came with the company in 1968, and there has been no indebtedness.

Q. Well, as you indicated, these companies, the German and English subsidiaries are more profitable than the parent, so they probably don't need loans now. But in the formation stages the parent was helping them to get started with loans was it not over and above the initial sixty-four thousand dollar investment, is that not true?

A. Yes.

Q. Now, with respect to the German operation you said that there was a four hundred thousand dollar loan or investment?

A. Based upon——

Q. After World War II?

A. Yes.

Q. And were there other loans made to the German operations, also, that were repaid over a period of time?

A. I don't know. There are no outstanding amounts at [p. 100] this time.

Q. Now?

A. And the only one that I have an inkling of is that four hundred thousand. I haven't specifically researched this.

Q. I see. You just don't know whether or not other amounts were—loans were made or not?

A. No.

Q. I have a statement here that I would like to read to you and tell me if this—the reason that I am reading this

to you, it is because you said something about you don't file consolidated returns of the German company.

Do the tax laws of the United States change with respect to filing consolidated returns with foreign subsidiaries—or have they—sometime in the last fifteen or eighteen years as far as you know?

A. As far as I know——

Q. Do you know the answer to that?

A. Well——

Q. Let me read this statement to you and you will understand why I am asking the question. It says, "As of 1960, the Woolworth financial statement as in the case of the Canadian and Mexican companies consolidates the German company. The annual report for that year states that this change was made by reason, 'the growing importance of our subsidiary companies.' [p. 101] When this course was decided upon Woolworth sent one of its officers and a representative of its auditing firm to Germany to direct the necessary changes in the accounting methods to accomplish the consolidation."

A. You didn't mentioned tax, just the consolidated financial reporting.

Q. I see. Let's go back, then. Maybe I misstated my question. Financial reporting is consolidated, then, is it not?

A. Yes.

Q. Is that what you are saying?

A. Yes.

Q. For all of the subsidiaries?

A. Yes, with the exception of England.

Q. Excuse me, maybe I had better be more specific. You have got a whole bunch of other stuff in your Taxpayer's Exhibit A.

The issue here is just England, Germany, Mexico and Canada. Now, all of those are consolidated returns except for England, is that correct?

A. Consolidated financial statements. You used the word "return".

Q. I am sorry. I beg your pardon. Financial statements, excuse me. Those financial statements are consolidated. And the English law prevents the——

[p. 102] A. No, it's the English company investment that is stated as a separate item in our financial statements because we do not own one hundred percent of them.

Q. Okay. So, you have a consolidated financial statement for the three subsidiaries that we are talking about and the English company, as I understand what you are saying, listed as a subsidiary?

A. It is listed as another—see, the assets and liabilities of the one hundred percent owned subsidiaries are consolidated in our financial statement.

In addition to the financial statement there is a line for our equity in the English company.

Q. Okay, thanks for clarifying that for me. I misspoke when I said return. There is a difference between a financial statement and a return.

A. There is some confusion in these areas and a lot of these articles or whatever that you are referring to.

Q. I am referring to the facts found by the New Jersey court.

So, just in summary, then, with respect to your testimony—on direct you were pointing out to us, then, that the day-to-day/minute-by-minute decisions, then, of necescity must be made by the officers of the corporation and are made independent of the parent by the Canadian, Mexican, German and English subsidiaries?

[p. 103] A. Yes.

Q. It is also not true, however, that the overall, in the big picture, the overall policy and direction of all of these subsidiaries is in line with the parent's thinking?

MR. BRAY: I would object to the question, too vague.

Q. (Mr. Kopel continuing.) Maybe I can rephrase the question.

MR. BRAY: I think we have been over this and I didn't object before——

Q. (Mr. Kopel continuing.) Well, what I am getting at, Mr. Feeley, and I am not trying to be obtuse about it, is that the parent company, Woolworth, has an obligation to its shareholders does it not?

A. In fact it does, yes.

Q. Of course, and the Board of Directors are responsible to the shareholders and elected by the shareholders are they not?

A. Yes.

Q. Would it be a fair statement to say that this Board of Directors of the parent would be derelict in its obligations to its shareholders if it did not oversee the operations of the subsidiaries?

A. Absolutely.

MR. KOPEL: I have no further questions.

[p. 104] MR. BRAY: I have no more questions.

MR. OWENS: I have a couple of quick questions.

EXAMINATION

BY MR. OWENS:

Q. The letterhead on the protests lists at the bottom several operations, Woolworth and Woolco, and what is Woolworth International?

A. Woolworth International is a finance company which owns—it's a Delaware corporation which has an investment in other Delaware corporations which own store locations in Spain.

Q. That's the Woolworth International Credit Corporation shown on Exhibit A?

A. Yes.

Q. Does Woolworth have a department or a section which devotes its activity to the foreign subsidiaries, an overseas division or whatever it might be called?

A. They have an individual who is designated as the International Vice President.

Q. International Vice President?

A. Who performs the function of liaison with the lesser subsidiaries such as the subsidiary in Spain and in Mexico and from time to time he may have contact with the major subsidiaries, if you will, of the company. This one individual's [p. 105] function is liaison.

Q. For the subsidiaries?

A. Yes.

Q. The less important subsidiaries?

A. Yes.

Q. But no section or department?

A. No, we do not.

Q. All right. Do you know, Mr. Feeley, if any of the officers in the taxable year that we are talking about, were any of these officers in any of the subsidiaries that we are talking about individuals who were people who started with the parent company and were transferred to one or more of the subs?

A. Not in the taxable year that we are talking about.

Q. Is there anybody who works on for the subsidiaries that we are talking about, are there any of those people who are in the parent company's pension program or profit sharing program or any program?

A. There are some members of the Canadian subsidiary and the Mexican subsidiary who are included in the Woolworth pension plan.

Q. On behalf of those individuals the parent company would pay the employees share of the contribution?

A. Yes. Excuse me, may I correct that? It's only the parent company's employees and the employees of the Mexican [p. 106] subsidiary—certain employees of the Mexican subsidiary—and the Spanish company are included in the pension plan of the Woolworth Company and the contribution made by the parent company. The Canadian company has been excluded.

Q. Are any of the officers of the four subsidiaries also paid by the parent company? What I am talking about is as you have indicated they are not expatriates, and some companies, parent companies, make up differences in remuneration?

A. Yes. None of the English people receive compensation from the parent company. None of the German people receive compensation from the parent company.

With respect to an individual in Spain on occasion there have been payments to make up the—for whatever reasons, the differential cost of living or tax break.

Similarly, there have been payments made with respect to the Mexican subsidiary.

None to my knowledge with respect to any of the Canadian people.

Q. One more clarification. I think you mentioned several times that the British and the German companies, in particular, grew because they were reinvesting. Do you mean investments of the foreign subsidiaries using its own earnings or making payments, dividend payments to the parent who then reinvests it?

A. With respect to the English company, the parent company [p. 107] did not reinvest dividends received from the English company.

With respect to the German company, the parent company did make reinvestment of a substantial portion of the dividends received from the German company.

MR. OWENS: That's all.

RECROSS EXAMINATION

BY MR. KOPEL:

Q. Just a few more questions, Mr. Feeley, if you don't mind.

Other non-business income in the schedules—it says foreign exchange gain on dividends received. Could you just clarify just exactly what that is, please?

A. Well, when the English company advises that—the parent company that it is going to pay a dividend of "X" number of pounds, say seven million pounds, as of a certain date, the parent company, in effect, insures receipt of that number of pounds in thirty or sixty days forward by entering into a foreign exchange contract.

As a result of the foreign exchange contract they are protected against receiving fewer pounds because of the exchange fluctuation, and in this particular case the fluctuation resulted in a profit.

Q. The dividend that the parent receives from the four subsidiaries that we are talking about, where do these [p. 108] dividends go?

A. They go into the general treasury of the company.

MR. KOPEL: I have no further questions, Your Honor.

EXAMINATION

BY MR. OWENS:

Q. One last question. I really don't understand that foreign exchange deal.

Does the English company declare a dividend in pounds or dollars?

A. In pounds.

Q. And the company, then, gets that same amount in pounds?

A. Yes, at some forward date.

Q. Yes. Then, when they sell those pounds I assume they find that it is of greater value?

A. At this particular time they did. Let's assume that the pound is equivalent to two dollars as it is now. They were notified by the English company that they were going to disburse a dividend in April of seven million pounds at two dollars a pound. That would be fourteen million dollars which we hope to receive.

So, in order to be sure that we do receive fourteen million dollars as of the stated date we pay at a premium, [p. 109] as it were, and we sell our right—a contract to receive the seven million pounds for something less.

So, that we can say that we would see them for a dollar ninety-five, and that's about the highest of a premium, something like that, and then we are assured that we are going to be receiving—we know what we have got in our hand and we expect to receive it in April.

We deliver—we may conclude that contract in April when the Engilsh company gives us the pounds and we give them to the purchaser.

We give them to them at the stated price which we received a dollar ninety-five for. At the same time the English company, then, disburses the pound to us and perhaps the market conditions are such that we can make fifty cents profit on the pound so that we will be getting two fifty. So, that is how a profit would arise.

The purpose of the hedge is to prevent a loss, but we can make a profit.

MR. KOPEL: You are saying in case the pound goes down appreciably is-a-vis the dollar?

A. That's right.

MR. OWENS: Mr. Bray, you indicated that this should be treated in the same fashion as dividends?

MR. BRAY: Yes. That's the purpose of the hedging transaction is to protect the value of the pound.

[p. 110] A. In another taxable transaction there will be a foreign exchange loss which would represent the insurance premium that we had paid for that protection.

Q. (Mr. Owens continuing.) You are talking about dividend income of sixty-five million on Taxpayer's Exhibit B, and that does not include the foreign exchange gain?

A. That's true.

Q. That means, then, that you didn't report this gain as dividend income and you didn't get a foreign tax credit on it, with respect to that gain?

A. That's right.

• • • • • • • • • • •

REPORT
CIT
Revised July, 1976

STATE OF NEW MEXICO
CORPORATION INCOME TAX RETURN

1975

Mail original of this return, any required schedules, and the tax due to the Bureau of Revenue, P. O. Box 630, Santa Fe, New Mexico 87503, on or before the 15th day of the third month following the close of the taxable year. Returns for the calendar year are due March 15, 1976. Tax due, if any must be paid in full. DO NOT MAIL CASH.

State of New Mexico
Bureau of Revenue

PLEASE PRINT OR TYPE CORRECT NAME, ADDRESS, & ZIP CODE BELOW

F.W. Woolworth Co.
233 Broadway
New York, New York 10007

NO

DO NOT WRITE IN THE SPACE ABOVE

NEW MEXICO BUREAU OF REVENUE ID NUMBER 01- 924756 -00-

☐ Calendar year ending 12-31-76 or
☐ Fiscal year beginning 2-1- '75 and ending 1-31-77

A. Incorporation: Date 12/15/11 State NEW YORK
B. Exact date business began in New Mexico 12/31/28
C. Accounting records are located at NEW YORK, NEW YORK
D. Kind of Business GENERAL RETAIL MERCANTILE
E. Was a New Mexico CIT-1 return filed for ~~1974~~ 1975? YES
If NO, explain
F. Does the corporation operate only in New Mexico? No

G. If, during the current tax period, the Federal Government has adjusted your Federal Taxable Income, state the years. NOTE: In all cases an amended return must be filed within 30 days from the date the adjustment becomes fixed, and attach copy of Revenue Agent Report(s)
H. List taxable years for which federal waivers of the statute of limitations were in effect as of the close of the fiscal year covered by this return and the dates on which the waivers expire
I. Federal Identification Number: 13-5423340

INCOME AND DEDUCTIONS

1. Total Income as shown on Federal Form 1120, Line 11	1	997,712,306
2. Federal Taxable Income as shown on Federal Form 1120, Line 30 or if separate accounting is used, attach schedule	2	87,603,761
3. Deductions		
A. Interest on obligations of the United States of America, to the extent included in Federal Taxable Income	3A	
B. Amounts taxed as income to another member of an affiliated group of Corporations under the Banking and Financial Corporation Tax Act (72-159-1 to 72-159-9); Attach schedule listing names and amounts	3B	
OR C. Non-New Mexico Income (For taxpayers operating BOTH within and without New Mexico (from Line 25 of Schedule B)	3C	87,519,090
D. Total of Lines 3A and 3B, OR Line 3C	3D	87,519,090
4. New Mexico Taxable Income (Line 2 less Line 3D)	4	84,671

TAX DUE

5. Tax on Line 4 above at 5% or Alternative Tax from Line 32, Schedule C	5	4231
6. Less tentative income tax payment	6	-
7. TAX DUE (line 5 less Line 6)	7	4231
8. Late Filing–Penalty (2% of Line 7 per month or partial month not to exceed 10%)	8	-
9. Late Filing–Interest (½% of Line 7 per month or partial month that this Report is late) Rec'd 12-15-77	9	127
10. TOTAL AMOUNT DUE (Add Lines 7, 8 and 9–Remit This Amount)	10	4358.00
11. OVERPAYMENT (Line 6 less Line 5–Refund Due) SEE ITEM L of INSTRUCTIONS	11	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than taxpayer, his declaration is based on all information of which he has any knowledge.

Signature of Officer — Asst Secy (Title) — 10/12/77 (Date)

Signature of individual or firm preparing the return — Address — Date

[EXHIBIT 11]
559

SCHEDULE B CIT-1 **ALLOCATION AND APPORTIONMENT OF INCOME** When reporting losses, show figures in brackets (

This schedule is to be used by taxpayers having income both within and without the State of New Mexico, and making the election to allocate and apportion. SEE INSTRUCTIONS.

Allocation of NET NONBUSINESS INCOME and Deduction of NET NONTAXABLE INCOME

1477107910 0

NET NONBUSINESS INCOME	Column 1 Total	Column 2 Less Related Expense	Column 3 Net	Column 4 Allocated To New Mexico
12. Dividends $_____ less federal special deductions from Schedule I, Federal Form 1120 $_____ 12	65323943		65323943	
13. Interest 13	2,350,141	✓	2,350,141	
14. Rents 14				
15. Royalties 15				
16. Profit or Loss on sale of Nonbusiness Assets 16				
17. Other Nonbusiness Income (Attach Schedule) 17	1595551	✓	1595551	
18. Partnership Income 18				
NET NONTAXABLE INCOME				
19. Interest on U.S. obligations to the extent included in Federal Taxable Income 19				
20. Amounts taxed as income to another member of an affiliated group of Corporations under the Banking and Financial Corporation Tax Act 20				
21. Total of Line 12 through Line 20 21	69329635		69329635	

BUSINESS INCOME		
22. Apportionable Business Income (Line 2, Page 1 less Line 21, Column 3) 22	18274068	
23. Apportion 4.6% (from Line 29B) of Line 22, as New Mexico Income 23		84622
24. New Mexico Taxable Income (Line 23 plus Line 21, Column 4) 24		84622
25. Non-New Mexico Income (Line 2, Page 1, less Line 24). Enter here and on Line 3C, Page 1 25		87519081

Apportionment Formula

		Column 5 Everywhere	Column 6 New Mexico	
26. Property Factor	A. Average yearly value of INVENTORY 26A.	79274698	2341638	
	B. Average yearly value of REAL and TANGIBLE PERSONAL PROPERTY used in the business including land, buildings, machinery and equipment, mobile equipment, furniture and fixtures, and other tangible assets (Attach Schedule) 26B.	340021098	1234922	
	C. RENTED PROPERTY (valued at annual rent paid times eight (8), enter net total) 26C.	1039265409	5168104	
	D. Total Property (Add Lines 26A, 26B and 26C) 26D.	1958029204	2750664	
	E. Property Factor (Line 26D, Column 6 divided by Line 26D, Column 5) 26E.			.001406712
27. Payroll Factor	A. Wages, salaries, commissions and other compensation of EMPLOYEES related to business income 27A.	432517253	1976850	
	B. Payroll Factor (Line 27A, Column 6 divided by Line 27A, Column 5) 27B.			.004573260
28. Sales Factor	A. Gross Receipts (other than items constituting nonbusiness income) including sales delivered or shipped TO NEW MEXICO FROM OUTSIDE New Mexico, sales delivered or shipped TO NEW MEXICO FROM WITHIN New Mexico, sales delivered or shipped FROM NEW MEXICO TO THE U.S. GOVERNMENT, and sales delivered or shipped FROM NEW MEXICO TO A STATE IN WHICH THE TAXPAYER IS NOT TAXABLE (Column 5 must equal Gross Receipts less returns and allowances) 28A.	2607993364	12252425	
	B. Sales Factor (Line 28A, Column 6, divided by Line 28A, Column 5) 28B.			.004698448
29. A. Total Percent (Add Lines 26E, 27B and 28B) 29A.				.010677220
B. Average Percent (Line 29A divided by 3, OR, if one or more of the factors is excluded, divide by the number of factors remaining SEE ITEM O of INSTRUCTIONS). Enter here and on Line 23 29B.				.003559073

SCHEDULE C—ALTERNATIVE TAX COMPUTATION

NOTE: May be used only by those Corporations (1) whose only activities in New Mexico consist of making sales; and (2) which do not own or rent real estate in New Mexico; and (3) whose annual gross sales in or into New Mexico amount to not more than $100,000.00.

30. Gross sales in or into New Mexico 30		
31. Tax rate 31		3%
32. Tax Due (Line 30 times Line 31) Enter on Line 5, Page 1 32		

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1976 or other taxable year beginning February 1, 1976, ending January 31, 19 77

1976

4 7 7 1 0 7 2 (PLEASE TYPE OR PRINT)

Check if—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See page 7 of instructions) 5300

Name: F. W. WOOLWORTH CO. (N.Y. CORP.)

Number and street: 233 BROADWAY

City or town, State, and ZIP code: NEW YORK, N.Y. 10007

D Employer Identification number: 13-5493340

E Date incorporated: Dec. 15, 1911

F Enter total assets from line 14, column (D), Schedule L (See instruction R) $

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction N.

GROSS INCOME	1	Gross receipts or gross sales ..... Less: Returns and allowances	1	2,477,269,025
	2	Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)	2	1,598,258,405
	3	Gross profit	3	879,010,620
	4	Dividends (Schedule C)	4	74,644,157
	5	Interest on obligations of the United States and U.S. instrumentalities	5	
	6	Other interest	6	3,533,766
	7	Gross rents	7	6,870,082
	8	Gross royalties	8	
	9	(a) Net capital gains (attach separate Schedule D)	9(a)	299,446
		(b) Ordinary gain or (loss) from Part II, Form 4797 (attach Form 4797)	9(b)	
	10	Other income (see instructions—attach schedule)	10	33,603,213
	11	TOTAL income—Add lines 3 through 10	11	997,961,284
DEDUCTIONS	12	Compensation of officers (Schedule E)	12	
	13	Salaries and wages (not deducted elsewhere)	13	458,378,809
	14	Repairs (see instructions)	14	17,362,871
	15	Bad debts (Schedule F if reserve method is used)	15	6,165,863
	16	Rents	16	137,780,086
	17	Taxes (attach schedule)	17	55,381,780
	18	Interest	18	44,830,646
	19	Contributions (not over 5% of line 30 adjusted per instructions—attach schedule)	19	838,289
	20	Amortization (attach schedule)	20	
	21	Depreciation (Schedule G)	21	23,525,380
	22	Depletion	22	
	23	Advertising	23	53,553,586
	24	Pension, profit sharing, etc. plans (see instructions) (enter number of plans ➤ .....)	24	12,457,090
	25	Employee benefit programs (see instructions)	25	
	26	Other deductions (attach schedule)	26	89,196,812
	27	TOTAL deductions—Add lines 12 through 26	27	899,476,212
	28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)	28	98,485,072
	29	Less: (a) Net operating loss deduction (see instructions—attach schedule) 29(a) 1,572,176		
		(b) Special deductions (Schedule I) 29(b) 9,260,214		10,832,390
	30	Taxable income (line 28 less line 29)	30	87,652,682
TAX	31	TOTAL TAX (Schedule J)	31	7,516,630
	32	Credits: (a) Overpayment from 1975 allowed as a credit		
		(b) 1976 estimated tax payments		
		(c) Less refund of 1976 estimated tax applied for on Form 4466 ( )		
		(d) Tax deposited with Form 7004 (attach copy)		
		(e) Tax deposited with Form 7005 (attach copy)		
		(f) Credit from regulated investment companies (attach Form 2439)		
		(g) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)		
	33	TAX DUE (line 31 less line 32). See instruction G for depositary method of payment	33	
	34	OVERPAYMENT (line 32 less line 31)	34	
	35	Enter amount of line 34 you want: Credited to 1977 estimated tax ➤ Refunded ➤	35	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which the preparer has any knowledge.

Date ..... Signature of officer .....

Title .....

Preparer's signature (and employer's name, if any) ..... Date

Identifying number (see instructions) ..... Address and ZIP code

Schedule A Cost of Goods Sold (See instructions 2)

1 Inventory at beginning of year		465,274,675
2 Merchandise bought for manufacture or sale		1616,840,864
3 Salaries and wages		9,092,359
4 Other costs (attach schedule)		903,824
5 Total		2,092,106,722
6 Less: Inventory at end of year		493,848,316
7 Cost of goods sold—Enter on line 2, page 1		1,598,258,405

Method of inventory valuation ➤ Lifo

Was there any substantial change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☒ No

If "Yes," attach explanation.

Schedule C Dividends (See instruction 4)

1 Domestic corporations subject to 85% deduction	
2 Certain preferred stock of public utilities	
3 Foreign corporations subject to 85% deduction	
4 Dividends from wholly-owned foreign subsidiaries subject to 100% deduction (section 245(b))	
5 Other dividends from foreign corporations	39,831,161
6 Includable income from controlled foreign corporations under subpart F (attach Forms 3646)	
7 Foreign dividend gross-up (section 78)	25,502,782
8 Qualifying dividends received from affiliated groups and subject to the 100% deduction (section 243 (a)(3))	9,260,214
9 Qualifying dividends received from affiliated groups and subject to the provisions of section 1564(a)	
10 Taxable dividends from a DISC or former DISC not included in line 1 (section 246(d))	
11 Other dividends	
12 Total—Enter here and on line 4, page 1	74,594,157

Schedule E Compensation of Officers (See instruction 12)

1. Name of officer	2. Social security number	3. Title	4. Time devoted to business	Percent of corporation stock owned 5. Common	6. Preferred	7. Amount of compensation	8. Expense account allowances

Total compensation of officers—Enter here and on line 12, page 1

Schedule F Bad Debts—Reserve Method (See instruction 13)

1. Year	2. Trade notes and accounts receivable outstanding at end of year	3. Sales on account	Amount added to reserve 4. Current year's provision	5.	6. Amount charged against reserve	7. Balance for bad debts at end of year
1972	100,271,255	150,523,456	4,174,461	Reserve	2,627,461	5,100,625
Jan. 1973	93,715,369	9,715,786	265,748	Transferred	325,081	5,041,092
Fiscal 1973	148,359,314	189,305,366	5,016,389	To	4,021,537	6,035,944
Fiscal 1974	139,660,013	211,538,138	9,559,206	GECC	6,543,830	9,071,320
Fiscal 1975	183,252,251	139,604,372	9,771,280	Jan.10,1977	10,017,562	8,824,938
Fiscal 1976	7,514,195	179,725,457	6,165,963	*(540,820)	10,629,981	3,809,000

Schedule G Depreciation (See instructions for Schedule G)

Note: If depreciation is computed by using the Class Life (ADR) System or the Guideline Class Life System, you must file Form 4832 (Class Life (ADR) System) or Form 5006 (Guideline Class Life System) with your return. Check box(es) if you made an election this taxable year to use ☐ Class Life (ADR) System and/or ☒ Guideline Class Life System. See Publication 534.

1. Group and guideline class or description of property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed or allowable in prior years	5. Method of computing depreciation	6. Life or rate	7. Depreciation for this year
1 Total additional first-year depreciation (do not include in items below) ➤						
2 Depreciation from Form 4832						17,486,670
3 Depreciation from Form 5006						4,960,750
4 Other depreciation:						
Buildings	Various					1,099,424
Furniture and fixtures						
Transportation equipment						
Machinery and other equipment						
Other (specify)	Less - F.W.W. CORP. (PA.)					(20,464)
5 Totals						
6 Less: Amount of depreciation claimed in Schedule A and elsewhere on the return						
7 Balance—Enter here and on line 21, page 1						23,525,380

Schedule C Special Deductions

1	(a) 85% of line 1, Schedule C	
	(b) 60.208% of line 2, Schedule C	
	(c) 85% of line 3, Schedule C	
	(d) 100% of line 4, Schedule C	-0-
2	Total—See instructions for limitation	9,260,214
3	100% of line 8, Schedule C	
4	Enter dividends received deduction allowed for dividends reported on line 9, Sch. C. See section 1564(b) for computation	
5	Dividends paid on certain preferred stock of public utilities (see instructions)	
6	Western Hemisphere trade corporations (see instructions)	
7	Total special deductions—Add lines 2 through 6. Enter here and on line 29(b), page 1	9,260,214

Schedule J Tax Computation

1	Taxable income (line 30, page 1)		87,652,682
2	Enter line 1 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)		25,000
3	Line 1 less line 2		87,627,682
4	Enter line 3 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)		25,000
5	Line 3 less line 4		87,602,682
6	20% of line 2		5,000
7	22% of line 4		5,500
8	48% of line 5		42,049,287
9	Income tax (Sum of lines 6, 7 and 8 or alternative tax from separate Schedule D, whichever is lesser)		42,005,887
10	(a) Foreign tax credit (attach Form 1118)	32,319,693	
	(b) Investment credit (attach Form 3468)	2,415,967	
	(c) Work incentive (WIN) credit (attach Form 4874)		
11	Total of lines 10(a), (b), and (c)		34,735,660
12	Line 9 less line 11		7,270,227
13	Personal holding company tax (attach Schedule PH (Form 1120))		
14	Tax from recomputing a prior year investment credit (attach Form 4255)		246,403
15	Tax from recomputing a prior year WIN credit (see instructions—attach computation)		
16	Minimum tax on tax preference items (see instructions—attach Form 4626)		
17	Total tax—Add lines 12 through 16. Enter here and on line 31, page 1		7,516,630

Schedule K Record of Federal Tax Deposits Class Tax Number 503 (List deposits in order of date made—See instruction G)

Date of deposit	Amount	Date of deposit	Amount	Date of deposit	Amount

		Yes	No
G	Did you claim a deduction for expenses connected with:		
	(1) Entertainment facility (boat, resort, ranch, etc.)?		X
	(2) Living accommodations (except for employees on business)?		X
	(3) Employees' families at conventions or meetings?		X
	(4) Employee or family vacations not reported on Form W-2?		X
H	(1) Did you at the end of the taxable year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).)	X	
	If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; and (c) taxable income or (loss) (e.g., if a Form 1120: from line 30, page 1, Form 1120) of such corporation for the taxable year ending with or within your taxable year.		
	(2) Did any individual, partnership, corporation, estate or trust at the end of the taxable year own, directly or indirectly, 50% or more of your voting stock? (For rules of attribution, see section 267(c).)		X
	If "Yes": (a) Attach a schedule showing name, address, and identifying number. (b) Enter percentage owned ► (c) Was the owner of such voting stock a person other than a U.S. person? (See instruction T.)		
	If "Yes," enter owner's country ►		X
I	Did you ever declare a stock dividend?		
J	Taxable income or (loss) from line 30, page 1, Form 1120 for your taxable year beginning in: 1973 108,552,542, 1974 71,861,679, 1975 70,701,857		
K	Were you a member of a controlled group subject to the provisions of Section 1561?	X	

		Yes	No
	If "Yes," check the type of relationship: (1) ☒ parent-subsidiary (2) ☐ brother-sister (3) ☐ combination of (1) and (2) (See section 1563.)		
L	Refer to page 7 of instructions and state the principal: Business activity Retail Trade Product or service General Merchandise		
M	Did you file all required Forms 1087, 1096 and 1099?	X	
N	Were you a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.)	X	
	If "Yes," attach Form 3646 for each such corporation.		
O	If you are a farmers' cooperative, check type: ☐ purchasing ☐ marketing ☐ service ☐ other (explain) ►		
P	During this taxable year, did you pay dividends (other than stock dividends and distributions in exchange for stock) in excess of your current and accumulated earnings and profits? (See sections 301 and 316.) If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.		X
Q	Did you, at any time during the taxable year, have any interest in or signature or other authority over a bank, securities, or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)? If "Yes," attach Form 4683. (For definitions, see Form 4683.)	X	
R	Were you the grantor of, or transferor to, a foreign trust during any taxable year, which foreign trust was in being during the current taxable year, whether or not you have any beneficial interest in such trust? If "Yes," attach Form 4683. (For definitions, see Form 4683.)		X

Schedule L Balance Sheets

	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
ASSETS				
1 Cash		20,006,818	129,412,465	2,570,412
2 Trade notes and accounts receivable	234,218,924			129,412,465
(a) Less allowance for bad debts		234,218,924		
3 Inventories		466,357,790		493,858,667
4 Gov't obligations: (a) U.S. and instrumentalities		9,265,281		9,421,918
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)		2,490,756		
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)		383,282,512		420,265,659
9 Buildings and other fixed depreciable assets	340,557,833		343,422,656	
(a) Less accumulated depreciation	164,635,512	175,922,321	172,077,954	171,344,702
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)		26,689,878		25,976,232
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)		86,834,104		83,268,958
14 Total assets		1,405,958,384		1,343,019,032
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable		91,305,547		108,748,826
16 Mtgs., notes, bonds payable in less than 1 yr.		12,251,651		9,665,988
17 Other current liabilities (attach schedule)		132,032,251		131,574,976
18 Loans from stockholders				
19 Mtgs., notes, bonds payable in 1 yr. or more		468,108,343		342,373,264
20 Other liabilities (attach schedule)		40,675,703		39,153,494
21 Capital stock: (a) Preferred stock	8,213,704		8,229,184	
(b) Common stock	97,869,492	106,103,196	97,874,099	105,103,283
22 Paid-in or capital surplus		323,048		323,048
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated		574,303,363		616,161,352
25 Less cost of treasury stock		(19,144,718)		(11,085,199)
26 Total liabilities and stockholders' equity		1,405,958,384		1,343,019,032

Schedule M-1 Reconciliation of Income per Books with Income per Return

1 Net income per books	86,604,269	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax	15,782,493	(a) Tax-exempt interest $	
3 Excess of capital losses over capital gains		See Schedule Attached	40,197,044
4 Income subject to tax not recorded on books this year (itemize) See Schedule Attached	33,122,386	8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		(a) Depreciation $	
(a) Depreciation $		(b) Depletion $	
(b) Depletion $		See Schedule Attached	307,059
Ordinary Loss y/e 1/31/76	48,979	9 Total of lines 7 and 8	40,504,103
See Schedule Attached	3,431,048	10 Income (line 28, page 1)—line 6 less 9	99,485,072
6 Total of lines 1 through 5	138,989,175		

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (line 24 above)

1 Balance at beginning of year	574,303,363	5 Distributions: (a) Cash	39,986,308
2 Net income per books	86,604,269	(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize) Employee Stock option and Purch. plan excess cost over amounts received	4,759,972
		7 Total of lines 5 and 6	44,746,280
4 Total of lines 1, 2, and 3	660,907,632	8 Balance at end of year (line 4 less 7)	616,161,352

☆ U.S. GOVERNMENT PRINTING OFFICE : 1976—O-214-266 1040-01-070

Assessment
RP-17
Revised Dec. 1975

STATE OF NEW MEXICO
BUREAU OF REVENUE

NOTICE OF ASSESSMENT OF TAXES

Commissioner
New Mexico Bureau of Revenue
P.O. Box 630
Santa Fe, New Mexico 87503

F.W. Woolworth Co.
233 Broadway
New York, New York 10007

Assessment No. 224952
Assessment Date 12/9/77
Interest Date 12-15-77
Reporting Period FYE 1-31-77
New Mexico ID or Social Security No. 01-002154-00 0

TYPE OF TAX	TAX DUE	PENALTY	INTEREST	TOTAL
CORPORATION INCOME TAX	15,844 82		633 79	16,478 61
	15,844 82		633 79	
TOTAL AMOUNT DUE				16,478 61

EXPLANATION OF LIABILITY

Office Audit by: Fabie Gonzales

Dated: 12-2-77

Demand is made for the immediate payment of this amount pursuant to Section 72-13-32, N.M.S.A. 1953. Failure to pay the total amount due within 30 days from the assessment date shown above will cause you to become a delinquent taxpayer under Section 72-13-31, N.M.S.A. 1953, and subject to your property and rights to property to seizure by levy under Section 72-13-45, N.M.S.A. 1953, unless, within 30 days from the assessment date shown above, (1) you furnish security for payment of the tax pursuant to Section 72-13-68, N.M.S.A. 1953, or (2) you protest pursuant to Section 72-13-38, N.M.S.A. 1953, or (3) the total amount of the tax is abated.

Any civil penalty or interest accruing after the interest date shown above may be collected in the same manner as and concurrently with, the tax to which it relates without assessment or separate proceeding of any kind.

The State of New Mexico has a lien upon all your property and rights to property by reason of this document to the extent provided in Section 72-13-51, N.M.S.A. 1953 and a notice of lien may be recorded pursuant to Section 72-13-52, N.M.S.A. 1953.

Please do not combine payment hereunder with your current tax payments. Please make your check payable to the Bureau of Revenue, attach it to the copy of this document provided for that purpose and mail to the address shown above.

FOR A STATEMENT OF TAXPAYER'S REMEDIES SEE REVERSE SIDE

Gicmv

COMMISSIONER OF REVENUE OR HIS DELEGATE

67a

[EXHIBIT 2]

NAME: F W Woolworth Co

ID: 11-0021541-16-6

YEAR: FYE 1-31-77

OFFICE AUDIT

DATE: 12-1-77

	1	2	3	4
			Erroneously Allocated Business Income	
Erroneously Allocated Business				
Dividends			$3383943	
Interest			2350141	
Rents				
Royalties				
Profit or Loss on sale of Assets				
Other Income			1595551	
Partnership Income				
TOTAL			$9329635	
Adjustment to Apportionment Percentage				
Sales Everywhere		25071990364		
Add: Line 89		9329635		
		25771319999		
New Mexico Sales			3253425	
Adjusted Sales Factor	.514233%			
Property Factor	.446912%			
Payroll Factor	.413860%			
Total	1.375005%			
Average	.458335%			
Adjustment to Apportionable Income				
Previously Reported		18274068		
Allocated Business Income		9329635		
Adjusted Apportionable Income		$27603703		
Adjustment to New Mexico Taxable Income				
Adjusted Apportionable Income	$27603703			
Apportionment Percentage	.458335%			
Adjusted N. M. Taxable Income	12651843			
Previously Reported	846222			
Taxable Deficiency		11805621		
Tax Rate		5%		
Tax Deficiency			590281	
Interest @ 1/2% per month for 8 month(s)			47580	
Total Amount Due				637861

[EXHIBIT 31]

69a

SUPREME COURT OF THE UNITED STATES

No. 80-1745

F. W. WOOLWORTH CO., *Appellant*,

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO

APPEAL from the Supreme Court of New Mexico.

The statement of jurisdiction in this case having been submitted and considered by the Court, in this case probable jurisdiction is noted. The case is set for oral argument in tandem with case No. 80-2015, *ASARCO Incorporated, etc.* v. *Idaho State Tax Commission.*

October 5, 1981

Office-Supreme Court, U.S.
FILED
MAY 26 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-1745

IN THE

Supreme Court of the United States

October Term, 1980

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

MOTION OF APPELLEE TO DISMISS OR AFFIRM

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No. 80-1745

IN THE

Supreme Court of the United States

October Term, 1980

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

MOTION OF APPELLEE TO DISMISS OR AFFIRM

The Appellee moves the Court to dismiss the appeal herein or, in the alternative, to affirm the judgment of the Supreme Court of New Mexico, on the ground that it is manifest that the questions on which the decision of the cause depends are so insubstantial as not to need further argument.

ARGUMENT

The primary constitutional issues raised by the appellant have been answered by this Court in its recent decisions in *Mobil Oil Corp. vs. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) and *Exxon Corp. vs. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). Appellant also raises some arguments in this Court which were never developed in the appropriate forum below, and consequently are not properly before this Court for review.

1. Woolworth's Dividend Income is Apportionable Business Income, Under *Mobil*.

In the context of income generated by the activities of an interstate business, the Due Process Clause of the United States Constitution imposes two restrictions on the power of the state to tax that income: first, there must be some minimal connection between those activities and the taxing state; and secondly, the income taxed by the state must be rationally related to "values connected with the taxing state." *Moorman Mfg. Co. vs. Bair*, 437 U.S. 267 (1978). Where the business is a unitary one, these requirements have been held to be satisfied by taxing schemes which apportion all the business income of the unitary business by means of a formula which compares the activities of the business within the taxing state relative to its activities everywhere. *Butler Bros. vs. McColgan*, 315 U.S. 501 (1942); *Bass, Ratcliff & Gretten, Ltd. vs. State Tax Commission*, 266 U.S. 271 (1924); *Underwood Typewriter Co. vs. Chamberlain*, 254 U.S. 113 (1920). If the business is a unitary one, then this apportionment formula obtains a "rough approximation" of the business income reasonably related to the taxing state. *Exxon Corp. vs. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). These general rules have been held applicable unless the taxpayer is able to show that the formula prescribed by the state operates to tax the taxpayer's income to a degree

out of all proportion to activities of the taxpayer in the taxing state. *Moorman Mfg. Co. vs. Bair, supra;* see, e.g., *Hans Rees' Sons, Inc. vs. North Carolina ex rel. Maxwell,* 283 U.S. 123 (1931).

This Court recently affirmed that these general rules apply to income from intangible, as well as tangible sources. This Court in *Mobil* addressed the question of

> whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad that precludes, as a constitutional matter, state taxation of that income by the apportionment method.
>
> 445 U.S. at 435.

This Court's conclusion was that there are no significant distinctions. Relying upon many of the cases cited above, this Court concluded:

> As these cases indicate, the linchpin of apportionability in the field of state taxation is the unitary business principle (fn. omitted). In accord with this principle, what appellant must show in order to establish that its dividend income is not subject to an apportioned tax in Vermont is that the income was earned in the course of activities unrelated to the sale of petroleum products in that state.
>
> 445 U.S. at 439.

Appellant interprets this paragraph and the language following it to require a court to determine whether the "underlying activity" of the "dividend-payor" is part of a "functionally integrated enterprise" being conducted by the resident corporation. In other words, appellant reads *Mobil* to require the dividend-payor corporation to be unitary with the dividend-recipient corporation, before the dividends received may be included in apportionable business income of the recipient. (Jurisdictional Statement, at 10). The Department submits that

such a reading of *Mobil* is overly broad. *Mobil* cannot be properly interpreted without reference to the cases on which the Court relies for its decision.[1] All these cases support the proposition that, if a taxpayer conducts a unitary business in more than one state, any of the taxing states may apply a tax to a reasonable portion of the entire unitary business income. Nothing in these preceeding cases can be found to require that the taxpayer be unitary with the *source* of its income. The Court in *Mobil* was not dealing with any dividend income paid from a source not unitary with the recipient, and expressly refused to reach that issue. 445 U.S. at 442. Once again, the Court rejected the argument that merely identifying a "source" for the income is sufficient to remove the amounts from apportionable income.

> Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.
>
> 445 U.S. at 438.

The focus, in determining whether income is business income, should be on the activities of the entity receiving income – is the income earned by the recipient in the regular course of its business?[2] Where the dividend-payor is unitary with the dividend-recipient, the business related nature of investment

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[1] I.e., *Butler Bros. vs. McColgan*, 315 U.S. 501 (1942); *Ford Motor Co. vs. Beauchamp*, 308 U.S. 331 (1939); *Moorman Mfg. Co. vs. Bair*, 437 U.S. 267 (1978); *Bass, Ratcliff & Gretten, Ltd. vs. State Tax Commission*, 266 U.S. 271 (1924); *Underwood Typewriter Co. vs. Chamberlain*, 254 U.S. 113 (1920). See *Mobil*, 445 U.S. at 438-439.

[2] See §7-4-2(A) N.M. Stat. Ann. (1978) set out in Appendix D of the Jurisdictional Statement.

income is obvious – the parent has invested its capital in order to expand its business, obtain a guaranteed source of supply or a steady market, or otherwise improve its business activities. See, e.g., *Montana Department of Revenue vs. American Smelting & Refining Co.*, 567 P.2d 901 (Mont. 1977), *appeal dismissed*, 434 U.S. 1042 (1978). However, investments may produce business income, even if the parent is not unitary with the subsidiary, if the taxpayer uses the income from such investments in its overall business operations. See, Dexter, *Business vs. Nonbusiness Distinction.* 10 URBAN LAWYER 243, 252 (Spring, 1978). It has long been recognized that the investments of a corporation may be integrally related with its business:

> Nor can it be justly said that the investments have no real relation to the business transacted by a corporation. The possession of large assets is a business advantage of great value; it may give credit which will result in more economical business methods; it may give a standing which shall facilitate purchases; it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige.
>
> *Flint vs. Stone Tracy Co.*, 220 U.S. 107 (1911).

This same relationship has been relied upon by many of the courts holding income from intangibles to be part of the apportionable business income of a taxpayer. E.g., *Qualls vs. Montgomery Ward & Co.*, 266 Ark. 186, 585 S.W.2d 18 (1979); *W. R. Grace & Co. vs. Commissioner of Revenue*, 393 N.E.2d 330 (Mass. 1979); *American Smelting & Refining Co. vs. Idaho State Tax Commission*, 592 P.2d 39 (Idaho 1979), *vacated and remanded*, 445 U.S. 939 (1980), *opinion reinstated* March 4, 1981.

Woolworth, throughout this litigation, has consistently confused the issues by failing to recognize the distinction between profits of the payor corporations and dividends received by

Woolworth from those corporations. Any question as to the existence of this distinction was laid to rest long ago by this Court:

> It is well settled that the property of the shareholders in their respective shares is distinct from the corporate property, franchises and capital stock, and may be separately taxed.
>
> *Hawley vs. Madden,*
> 232 U.S. 1 (1914).[3]

Indeed, there is no necessary relation between the amount of profits received by a particular corporation and the amount of dividends passed along to its stockholders. *Mobil,* 445 U.S. at 460, n. 18 (Justice Stevens dissenting).

Woolworth's argument that extra-territorial values are being taxed is based on the premise that the location of its investment is in a foreign country. On the contrary, the income upon which Woolworth is being taxed is its income from intangibles, the location of which we cannot discern from the record. Since the dividend income is used for the general operating expenses of the corporation, there is no apparent reason for treating this income differently from any other type of business income of the unitary business.[4] The analysis of the Vermont Supreme Court in *In re Goodyear Tire & Rubber Co.,* 133 Vt. 132, 335 A.2d 310 (1975) reflects this approach. The New Mexico Supreme Court applied a similar analysis, in determining the

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[3] See also, *Klein vs. Board of Tax Supervisors,* 282 U.S. 19 (1930): "There's no doubt that a state may tax a corporation and also tax the holders of its stock. . . . The owners are different and . . . the property is different." For a detailed discussion of this idea, see Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations,* 29 VAND. L. REV. 401 (1976).

[4] Woolworth conceded at the outset of litigation that its domestic retail business is a unitary one. Taxpayer's memorandum of Law and Facts, at p. 8, submitted to Hearing Examiner.

"business" nature of the income. *Taxation and Revenue Department vs. F. W. Woolworth*, 624 P.2d 28, 34-35 (N.M. 1981). (Jurisdictional Statement, Appendix A.) *Accord, Tipperary Corp. vs. New Mexico Bureau of Revenue*, 93 N.M. 22, 595 P.2d 1212 (Ct.App. 1979), *cert. denied*, 92 N.M. 675, 593 P.2d 1078 (1979); *Champion International Corp. vs. Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App.), *cert. denied*, 89 N.M. 5, 546 P.2d 70 (1975).

Even if we accept *arguendo* Woolworth's argument that the Court's holding in *Mobil* requires unitariness between payor and payee corporations, that argument does not aid Woolworth, since that corporation is in fact unitary with the four subsidiaries under consideration here:

> On the due process issue and in conformity with *Mobil*, we hold that, for income tax considerations, there is substantial evidence in this record that Woolworth was conducting a unitary business with its foreign subsidiaries and that there is a sufficient nexus between the corporation and the state of New Mexico to justify an apportioned tax on these dividends. The income is obviously related to the mutual activities of the parent and its affiliates. The control over the subsidiaries, the interdependence, the history of the relationships, the placing of the money in the general operating account, all point to functional integration and reveal an underlying unitary business for our purposes here.
>
> *Taxation and Revenue Department vs. F. W. Woolworth*, 624 P.2d at 38.

Woolworth makes much of the evidence that its foreign subsidiaries were left to their own devices most of the time. Similar evidence was introduced in *W. R. Grace & Co. vs. Commissioner of Revenue*, 393 N.E.2d at 336:

> Close functional integration of each arm of a business organism is not an essential element of unitariness. The

> record shows Grace owned a majority share of Miller. Its president sat on Miller's board of directors. The investment world had notice of Grace's position with respect to Miller, and of the potentiality for, if not actual exercise of, its assumption of operational control. Grace apparently chose to refrain from active management in anticipation of its complete ownership of the Miller business. That political decision, however, did not serve to nullify the essentially unitary character of Grace's relationship with its Miller holding.

Although the purpose for which investments were acquired has frequently been a criterion for determining whether investment income is part of the unitary business,[5] the record before the hearing examiner was devoid of any information concerning the purposes for acquisition of shares. Indeed, it is highly possible that Woolworth's investments in foreign countries by means of independent subsidiary corporations were considered by Woolworth at the time they were made as the most desirable and potentially lucrative method for extending its unitary business into foreign countries.[6] Woolworth's failure to develop any evidence on this point or on any special use of the income in question may be fairly interpreted to indicate that the evidence, if known, would not support the taxpayer, since it is the taxpayer's burden to negate the existence of unitariness. *Mobil, supra.*

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[5] E.g., *Champion International Corp. vs. Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App.), *cert. den.* 89 N.M. 5, 546 P.2d 70 (1975).

[6] Prior to 1962, many domestic corporations found it advantageous to form subsidiaries to conduct their foreign business rather than mere operating divisions, because of certain tax advantages. *Dow Chemical Co. vs. Commissioner of Revenue*, 391 N.E.2d 253 (Mass. 1979). See also, *Montana Department of Revenue vs. American Smelting & Refining Co.*, 567 P.2d 901 (Mont. 1977), *appeal dismissed*, 434 U.S. 1042 (1978).

2. Inclusion of Gross-Up in Apportionable Business Income Is Not a Question of Constitutional Significance.

New Mexico gauges its income tax by the amount a taxpayer reports as federal taxable income. Section 7-2-2(S) N.M. Stat. Ann. (1978). (Jurisdictional Statement, Appendix D) As appellant concedes (Jurisdictional Statement, p. 14, n. 14), such a system is ordinarily desirable, providing simplicity for both the taxpayer and the state. *Getty Oil Co. vs. Taxation and Revenue Department*, 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct.App. 1979). That the system is a desirable one, from a state's point of view, is evidenced by its popularity among the states.

Many states, by statute, have created a deduction from federal taxable income for "gross-up."[7] A judicial requirement that "gross-up" must be excluded from federal taxable income, in calculating New Mexico taxable income, is equivalent to providing for a non-statutory deduction, as the New Mexico Supreme Court correctly held. *Taxation and Revenue Dept. vs. F. W. Woolworth*, 624 P.2d at 32. Creation of such deductions by interpretation are traditionally disfavored.[8] Despite the existence of numerous situations in the Internal Revenue Code wherein "taxable income" includes amounts which the taxpayer did not actually receive in an ordinary "income" sense, Woolworth has indicated no instance wherein this Court

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[7] Massachusetts, for example, allows a deduction for dividends included in that income in the taxable year. *Dow Chemical Co. vs. Commissioner of Revenue*, 391 N.E.2d 253 (Mass. 1979).

[8] See, e.g., *Champion International Corp. vs. Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App.) *cert. den.* 89, N.M. 5, 546 P.2d 70 (1975); *Garlin vs. Murphy*, 51 Misc.2d 477, 273 N.Y.S.2d 374 (1976), *aff'd*, 34 N.Y.2d 921; *Commonwealth vs. Electrolux*, 362 Pa. 333, 67 A.2d 105 (1949); *Ebling Co. vs. Graves*, 259 App. Div. 427, 20 N.Y.S.2d 123 (1940), *aff'd*, 30 N.E.2d 726 (1940); *Katzenburg vs. Comptroller of the Treasury*, 263 Md. 189, 282 A.2d 465 (Ct.App. 1971).

has held that inclusion by a state of any of these artificial amounts violates the United States Constitution.[9] For example, in addition to gross-up, Subpart F income,[10] the federal jobs credit[11] and other federal provisions[12] provide in some instances for the artificial increase or failure to decrease "taxable income," in order to provide certain tax benefits to the claimant. To judicially create deductions not provided by statute would effectively destroy the ability of states to statutorily base their income taxes on the federal income tax; such a ruling would go far beyond the time honored bounds described by Justice Frankfurter in *Wisconsin vs. J. C. Penney Co.*, 311 U.S. 435, 444 (1941):

> A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.

The mere fact that different states have different legislative opinions regarding the propriety of including such items as gross-up in taxable income does not elevate the inquiry to one of constitutional significance. *Moorman Mfg. Co. vs. Bair, supra.* The appropriate due process analysis is whether the state is taxing value out of all proportion to values connected with the

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[9] Woolworth's reliance on *In re Appeal of Norris Knosher,* (No. 203-80, decided Feb. 3, 1981, Vt.S.Ct.) is of no assistance to it. That case turned on the court's statutory interpretation of a statute dissimilar to New Mexico's.

[10] I.R.C. §§951-964; See *Dow Chemical Co. vs. Comm'r. of Revenue,* 391 N.E.2d 253 (Mass. 1979).

[11] I.R.C. §280C(a); I.R.C. §40; and I.R.C. §§50 A & B.

[12] E.G., I.R.C. §631(a); See *Champion International Corp. vs. Bureau of Revenue, supra.*

taxing state. *Moorman Mfg. Co. vs. Bair, supra; Hans Rees' Sons, Inc. vs. North Carolina ex rel. Maxwell, supra.* Although *Moorman* and many other cases make it clear that the burden of demonstrating such lack of proportionality rests squarely upon the shoulders of the taxpayer, there is no evidence at all in this record showing or tending to show such lack of proportionality. Cf., *Hans Rees' Sons, Inc. vs. North Carolina ex rel. Maxwell, supra; Norfolk & Western Ry. Co. vs. Missouri State Tax Comm'n.*, 390 U.S. 317 (1968).

The taxpayer elected to add to its federal taxable income certain amounts so that it could receive a substantial credit on its federal income taxes. I.R.C. §§78, 902(a) and 960(a)(1). Nothing in New Mexico law relieves them of the consequences of that election for state tax purposes. *Accord, Caterpillar Tractor Co. vs. Lenckos,* 77 Ill.App.3rd 90, 395 N.E.2d 1167 (1979), *aff'd* February 20, 1981, Ill.S.Ct. Moreover, while the gross-up does not fit within the commonly accepted notion of what income is,[13] it is clear that the taxpayer receives a substantial accretion to wealth by using the federal construct, an accretion to which it would not have been entitled, in the absence of federal legislation. The record shows that Woolworth was relieved of $25,502,782 of federal taxes which otherwise would have been due and payable by Woolworth, by virtue of being allowed to claim, as its own, foreign taxes which were actually paid by another person. In short, Woolworth pocketed $25,502,782 which it otherwise would not have had. Certainly this is a gain or benefit to a taxpayer sufficient to justify inclusion of the amount in taxable income. *In re Goodyear Tire & Rubber Co., supra; Albany International Corp. vs. Halperin,* 388 A.2d 902 (Me. 1978).

Since the gross-up is treated by federal tax law as a deemed received dividend, I.R.C. §78, it should retain its character as a

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[13] See *Dow Chemical Co. vs. Commissioner of Revenue,* 391 N.E.2d at 265.

dividend for state taxation purposes.[14] *Dow Chemical Co. vs. Commissioner of Revenue,* 391 N.E.2d at 265. If it is accepted that gross-up can be included in the taxable income reported to a state and if it retains its character as dividends, then it becomes in fact indistinguishable from other dividends paid by the foreign subsidiary corporation to its parent; obviously it should be included in business income, as other foreign source dividend income is included in the business income of a domestic parent corporation.

3. Appellant's Commerce Clause Argument Was Not Properly Raised Below, and Has No Merit.

The New Mexico Supreme Court held that Woolworth's claims as to violations of the Commerce Clause were answered against it by the Supreme Court in *Mobil. Taxation and Revenue Department vs. F. W. Woolworth,* 624 P.2d at 38. Woolworth now contends that "*any* state taxation (even by the state of commercial domicile) 'creates more than the risk of multiple taxation; it creates multiple taxation in fact.' " For this proposition, Woolworth relies upon *Japan Line, Ltd. vs. County of Los Angeles,* 441 U.S. 434 (1979). (Jurisdictional Statement, p. 20) This argument is a different one from any that was ever raised before in this proceeding.

Before the hearing examiner, Woolworth argued:

> Woolworth contends that the dividend income received from its foreign subsidiaries does not constitute 'business

[14] This treatment of the gross-up is especially reasonable, when the rationale behind gross-up is examined. Since Congress allowed a domestic corporation to claim a credit for foreign taxes actually paid by its foreign subsidiaries, the gross-up increases the domestic corporation's income to reflect the amount that it would have received as dividends from its foreign subsidiaries, had they not been required to pay those foreign taxes. *American Chicle Co. vs. United States,* 316 U.S. 450 (1942).

> income' within the meaning of the New Mexico statute and therefore such dividend income should not be included in apportionable income but should be separately allocated to Woolworth's state of commercial domicile.
>
> Taxpayer's Memorandum of Law and Facts, at p. 5, submitted to Hearing Examiner and adopted as Brief-in-Chief in Court of Appeals.

Further, in the New Mexico Supreme Court, Woolworth argued: "if gross-up is non-business income it is allocated to the state of New York, Woolworth's commercial domicile." (Brief of Respondent Taxpayer, at 27, submitted in New Mexico Supreme Court) The issue raised below was conclusively decided by this Court in the *Mobil* case. The Court noted that, by requesting allocation, Mobil was foregoing the contention that local duplication of a foreign tax was completely proscribed; this Court further discussed the logical inconsistencies in allowing allocation but not apportionment, in face of the Commerce Clause challenge, since allocation would not necessarily result in a lesser tax burden. *Mobil Oil Corp. vs. Commissioner of Taxes of Vermont,* 445 U.S. at 446-447. In light of *Mobil's* holding, Woolworth has refined its argument, so that it now contends that *any* state taxation of dividend income violates the Commerce Clause. (Jurisdictional Statement, at 20).

The proper time to raise Woolworth's argument that any state taxation of foreign dividends violates the Commerce Clause was at the formal hearing before the hearing examiner. Section 7-1-25(A) N.M. Stat. Ann. (1978). *New Mexico Sheriff's & Police Ass'n. vs. Bureau of Revenue,* 85 N.M. 565, 514 P.2d 616 (Ct.App. 1973); *Till vs. Jones,* 83 N.M. 743, 497 P.2d 745 (Ct.App.), *cert. denied,* 83 N.M. 740, 497 P.2d 742 (1972). This Court has traditionally avoided deciding constitutional questions not properly raised in the state courts below. *Wilson vs. Cook,* 327 U.S. 474, 483-484 (1946).

Even had Woolworth properly raised the question below, the Department submits that its claim is meritless. This Court in *Mobil* rejected any attempt to apply the reasoning from *Japan Line,* a case dealing with ad valorem property taxes assessed directly upon instrumentalities of foreign commerce, to an income tax case. The Court reasoned as follows:

> Concurrent federal and state taxation of income, of course, is a well established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income.
>
> 445 U.S. at 448.

Therefore, the Department submits that no provision of the Commerce Clause is violated by inclusion in apportionable business income dividends and "gross-up" received or deemed received by a business from its foreign subsidiaries.

4. Woolworth Has Made No Showing of Appropriate Adjustments to the Apportionment Formula.

Here, as in *Mobil,* the taxpayer concentrated its efforts in the lower courts to "achieve the subtraction of the asserted nonapportionable income from the pre-apportionment tax base." *Mobil Oil Corp. vs. Commissioner of Taxes of Vermont,* 445 U.S. at 432. Woolworth's discussion before the Hearing Officer of the apportionment formula appeared as follows:

> Woolworth feels that the apportionment formula should be modified as provided in Section 72-15A-39 of the Tax Act [now Section 7-4-19 N.M. Stat. Ann. (1978)] so as to fairly represent Woolworth's activities in New Mexico. Accordingly, Woolworth hereby petitions the New

> Mexico Commissioner of Revenue to add the property, payroll and sales of its foreign subsidiaries to the property, payroll and sales of Woolworth under the three-factor apportionment formula. Woolworth further requests, in the alternative, that the Commissioner modify the formula in any other manner he deems reasonable so as to fairly represent the extent of Woolworth's business activities in New Mexico. This might be accomplished, for example, by excluding the dividends (both cash and gross-up) from apportionable income in the Kentucky manner.
>
> Taxpayer's Memorandum of Law and Facts, filed with Hearing Officer, at pages 21 and 22.

There is no indication in the record of the nature of the taxpayer's activities in New Mexico.[15] Nor is there even a suggestion in this record of what the property, payroll and sales of its foreign subsidiaries were during the tax period. The New Mexico Supreme Court properly concluded, on this record, that the taxpayer had failed to meet its burden of proof in attacking the apportionment formula: "one who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extra-territorial values being taxed." *Butler Bros. vs. McColgan, supra; Moorman Mfg. Co. vs. Bair,* 437 U.S. 267 (1978); *Gulf Oil vs. Morrison,* 120 Vt. 324, 141 A.2d 671 (1958); *W. R. Grace & Co. vs. Commissioner of Revenue,* 393 N.E.2d 330 (Mass. 1979).

Nor are the cases cited by taxpayer of any help in this regard. Contrasted with Woolworth, the taxpayers in those cases

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[15] Although a careful examination of the exhibits reveals the exact amount of the apportionment percentage, .463073% (representing the ratio of Woolworth's tangible property, payroll, and sales in New Mexico to the same items everywhere) (Transcript, p. 168), there is no indication of what activities this ratio represents.

presented voluminous evidence to meet their burdens of showing that the apportionment formulas as applied to them resulted in taxing them "out of all appropriate proportion to the business transacted in that state"[16] or "led to a grossly distorted result."[17]

CONCLUSION

Appellee Taxation and Revenue Department of the State of New Mexico respectfully submits that the questions upon which this cause depends are so insubstantial as not to need further argument, and Appellee respectfully moves the Court to dismiss this appeal, or, in the alternative, to affirm the judgment entered in the cause by the Supreme Court of New Mexico.

Respectfully submitted,

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[16] *Hans Rees' Sons, Inc. vs. North Carolina ex rel Maxwell,* 283 U.S. 123 (1931).

[17] *Norfolk & Western Ry. Co. vs. Missouri State Tax Commission,* 390 U.S. 317 (1968).

CERTIFICATE OF SERVICE

I hereby certify that on the ____ day of May, 1981, I, Sarah E. Bennett, a member of the bar of the Supreme Court, caused to be mailed, postage prepaid, three copies of the foregoing Motion to Dismiss or Affirm to George W. Beatty and William L. Goldman, Counsel for the Appellant, at 1200 - 18th Street, NW, Washington, D.C. 20036 and to Michael D. Bray, at 919 Third Avenue, New York, New York 10022. I further certify that all parties required to be served have been served.

SARAH E. BENNETT
Assistant Attorney General

Office-Supreme Court, U.S.
FILED
MAY 26 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-1745

IN THE

Supreme Court of the United States

October Term, 1980

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

BRIEF OF AMICUS CURIAE MULTISTATE TAX COMMISSION IN SUPPORT OF APPELLEE'S MOTION TO DISMISS OR AFFIRM

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BRIEF OF AMICUS CURIAE MULTISTATE TAX COMMISSION IN SUPPORT OF APPELLEE'S MOTION TO DISMISS OR AFFIRM

INTRODUCTORY STATEMENT

This brief is submitted by the Multistate Tax Commission in support of the Appellee's Motion to Dismiss or Affirm. Both parties of this proceeding have consented to the filing of this brief.[1]

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[1] Originals of the consent letters have been filed with the Clerk of Court.

STATEMENT OF INTEREST

The Multistate Tax Commission (hereinafter referred to as the Commission) is the official administrative agency of the Multistate Tax Compact (hereinafter referred to as the Compact) entered into currently by 19 states as full members, including New Mexico, and by 12 states as associate members.[2]

The purposes of the Compact are to:

1. Facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatability in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicate taxation.[3]

In fulfillment of these objectives, in the area of state income taxation of multistate-multinational business, Article IV of the

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[2] The current regular members are the states of Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Michigan, Missouri, Montana, Nebraska, New Mexico, Nevada, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. The associate members are the states of Alabama, Arizona, Georgia, Louisiana, Maryland, Massachusetts, Minnesota, New Jersey, Ohio, Pennsylvania, Tennessee, and West Virginia. (Ninth Annual Report, Multistate Tax Commission, June 30, 1976).

[3] The constitutionality of the Compact was upheld by the United States Supreme Court in *U.S. Steel, et al. v. Multistate Tax Commission, et al.*, 434 U.S. 452 (1978), affirming 417 F.Supp. 795 (S.D.N.Y. 1976). The Court there noted that the Compact ". . . symbolized the recognition that, as applied to multistate businesses, traditional state tax administration was inefficient and costly to both state and taxpayer."

Compact sets forth the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).[4] The purpose of UDITPA is to provide for the uniform allocation and apportionment of income for state income tax purposes by those states that have adopted it. It has been adopted by a great majority of the income tax states.[5] It applies to all classes of taxpayers (individuals, partnerships, etc.) except financial institutions and public utilities. It provides for the specific allocation or apportionment of all the income of all the included taxpayers except the personal service income of individuals. UDITPA apportions "business income" in accordance with the well-recognized three-factor apportionment formula of property, payroll and sales. "Nonbusiness income" is specifically allocated as provided for therein.[6]

Pursuant to its authority under Article VII of the Compact, the Commission approved revised uniform allocation and apportionment regulations on February 21, 1973, which implement UDITPA. New Mexico and approximately 17 other states have adopted these regulations substantially in the form as adopted

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[4] UDITPA was promulgated by the National Conference of Commissioners on Uniform State Laws in 1957. Uniform Laws Annotated, Vol. 9A, p. 448, *et seq.*

[5] 11th Annual Report of the Multistate Tax Commission, 1977-1978, App. B, p. 28.

[6] Section 1(a) of UDITPA defines "business income" as:

> Income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Section 1(e) defines nonbusiness income subject to specific allocation as "all income other than business income."

by the Commission.[7] These regulations embody an interpretation of the language of UDITPA.

It is important that the UDITPA provisions be interpreted to carry out the purpose of the 29 states, including New Mexico, in adopting the uniform allocation and apportionment rules contained therein. This purpose is to provide for uniformity and full accountability (without duplication) in the division of income for state income tax purposes by workable and rational division of income rules.[8]

The Commission and its member states are concerned with the proposition advanced by Woolworth that, under the United States Constitution, dividends, and presumably other income from business-related intangible property, must be arbitrarily assigned, for state income tax attribution purposes, to the commercial domicile or to the location of the payors of the income, rather than to where the taxpayer utilizes these intangible properties in the conduct of its unitary business activities, as required by a reasonable interpretation and application of the UDITPA definition of "business income".

More particularly, in the instant matter, the Commission and its member states are concerned with the novel proposition, advanced by Woolworth, that *Mobil Oil Corp. v. Comm'r. of Taxes of Vermont*, 445 U.S. 425 (1980), supports the proposition that only income from investments in stock of payors, which conduct a unitary business with a payee taxpayer for

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[7] Results of a survey on the Uniformity of State Laws by the State of Indiana dated February 15, 1977.

[8] Prefatory note to UDITPA, Uniform Laws Annotated, Vol. 9A, p. 448; *GTE Automatic Electric v. Allpin*, 68 Ill.2d 326, 369 N.E.2d 941 (1977) and Pierce, "The Uniform Division of Income for State Tax Purposes," 35 Taxes 747 at 748 and 749 (1957).

"combined reporting" purposes, is apportionable; and, if apportionable, must, as a matter of constitutional law, be apportioned on the basis of the business activities of the payor corporations. The acceptance of this argument would require this Court to declare the attribution provisions of UDITPA unconstitutional even though UDITPA requires apportionment of only the unitary income of a unitary business which is carried on in part in the taxing state. The purpose of this brief is to demonstrate that *Mobil* and other controlling decisions of this Court preclude any such result and indicate that this Court should either dismiss this appeal for want of a substantial federal question or affirm the decision below of the New Mexico Supreme Court.

As a subsidiary matter, the Commission and member states are also concerned with Woolworth's position that the states are constitutionally precluded from defining taxable income by utilizing federal taxable income as a starting point for the purpose of state income taxes because federal taxable income is unreliable for this purpose.

COUNTER STATEMENT OF THE CASE

The Commission accepts Woolworth's Statement of the Case except it *disagrees* with Woolworth's statements pertaining to its relationship with its four subsidiaries from which it derived the dividends in question and with the Statement's omission of important facts.

Irrespective of how this relationship is described and characterized, it is important to note that there is no claim made by Woolworth that it, as a single corporate entity, did not conduct all of its own business operations as a single unitary business nor that the dividends in question did not result from stock investments to further its own business operations as a single corporate entity. In short, there is nothing in the record to establish that the dividends in question were not a part of

Woolworth's unitary business operations which it conducted in part in New Mexico for the year in question. Neither is there anything in the record to establish that the UDITPA apportionment formula, as applied to its total income from its unitary business, assigns any income to New Mexico not reasonably related to its New Mexico activities for the year in question.

The facts concerning Woolworth's relationship with these subsidiaries are set forth on pages 8a-9a of the Jurisdictional Statement. Based on these facts and its examination of the entire record, the New Mexico Supreme Court concluded:

> On the due process issue and in conformity with *Mobil*, we hold that, for income tax considerations, there is substantial evidence in this record that Woolworth was conducting a unitary business with its foreign subsidiaries and that there is a sufficient nexus between the corporation and the State of New Mexico to justify an apportioned tax on these dividends. The income is obviously related to the mutual activities of the parent and its affiliates. The control over the subsidiaries, the interdependence, the history of the relationships, the placing of the money in the general operating account, all point to functional integration and reveal an underlying unitary business for our purposes here.
>
> Juris.St., p. 19a

The fact that the foregoing findings and conclusion of the New Mexico Supreme Court is supported by the record is demonstrated by the following facts taken from the transcript of the proceedings below.

Woolworth's foreign subsidiaries, under the Woolworth name (TR 68), conduct the same type of retail operations as does Woolworth (TR 67). Woolworth's overall financing and planning included and was integrated with that of its foreign subsidiaries (TR 75-76). There was a substantial exchange of business information between Woolworth and its foreign subsidiary

corporations through a teletype communications system and travel of executive personnel of both the foreign subsidiaries and Woolworth (TR 84-86). There was a healthy exchange of information between Woolworth and its subsidiaries on a regular basis at the highest levels (TR 85-86). This was particularly true with regard to major decisions (TR 88). Any substantial borrowing of the foreign subsidiaries required approval of Woolworth (TR 76). To what extent there was a flow of goods between Woolworth and its foreign subsidiaries is not known (TR 96). However, there was some, as well as a flow of financial resources (TR 98). While the record is not clear as to the actual degree of control Woolworth's board of directors exercised over its foreign subsidiary corporations, it did oversee these operations (TR 103). Management responsibilities were given by Woolworth to its foreign subsidiaries only commensurate with the development of their abilities to act independent of Woolworth (TR 78). Also, there are interlocking directors and executive personnel between that of Woolworth and its foreign subsidiaries (TR 72, 77, 90, 93). To this end, Woolworth has an international vice-president (TR 104). Woolworth controlled major decisions and transactions of its subsidiaries (TR 74, 76). Although there is evidence in the record that there were no transfers of individuals from Woolworth to its subsidiaries in the taxable year in question (TR 105), there is no evidence that there was not substantial transfers of such personnel in other years (TR 107). The record further establishes that Woolworth made various other financial commitments to its overseas subsidiary corporations, in addition to its initial investment, in the form of loans and reinvestments (TR 107, 62, 76). The managing directors of the foreign subsidiaries and affiliates in question were selected by Woolworth (TR 81-82). The dividend policies of the subsidiary and affiliated corporations in question are determined by Woolworth (TR 83).

Thus, while the record in this cause is far from complete concerning Woolworth's business relationships with its subsidiary

corporations in question, there can be no doubt that, as a factual proposition, Woolworth had substantial unitary ties with them.[9]

THE COURT SHOULD EITHER DISMISS THIS APPEAL OR AFFIRM THE DECISION BELOW BECAUSE WOOLWORTH HAS RAISED NO SUBSTANTIAL FEDERAL QUESTION.

A. Assuming *arguendo*, that New Mexico could include in the apportionable income of the taxpayer, only the dividends from corporations which conduct a unitary business with the taxpayer, Woolworth is not entitled to have the dividends in question excluded from apportionable income because the record in this cause amply supports the finding of the Court below that Woolworth did conduct a unitary business with its foreign subsidiary corporations for the year in question.

The foregoing statement is amply supported by the record in this cause and needs no further elaboration here. Woolworth's foreign subsidiaries were created and utilized by it to conduct a functionally-integrated worldwide retail business. It utilized its resources, as a parent company, for this purpose. Under no stretch of the imagination can the operations of the subsidiaries in question be classified as discrete business enterprises disassociated for due process purposes from the business enterprise of Woolworth. Thus, however *Mobil* is construed, it supports the judgment of the Court below. Woolworth has thus raised no substantial federal question as to the apportionability of the dividends in question.

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[9] For a more complete statement of these ties for prior years, see *F. W. Woolworth Co. v. Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965).

B. Neither *Mobil* nor any other precedent of this Court limits the apportionability of dividends to only those dividends which are received from a taxpayer which conducts a unitary business with the business of the payor corporations.

Apart from ignoring the facts which are here controlling, Woolworth argues that *Mobil* precludes the apportionment of any dividends unless the payor corporations conduct a unitary business with the payee taxpayer. It then urges this Court to take jurisdiction of this case to determine what facts are necessary to support a finding of a unitary business for this purpose.

This position of Woolworth is not supported by any rational analysis of *Mobil* or the due process or commerce clause restrictions on state taxing powers, as affirmed in *Mobil.* Dividends held apportionable in *Mobil* included minority stockholdings. This is amply demonstrated by Mobil's 10% ownership of stock in ARAMCO.

The key language in *Mobil* is the statement:

> *As these cases indicate,* the linchpin of apportionability in the field of state income taxation is the unitary business principle. *In accordance with this principle, what appellant must show,* in order to establish that its dividend income is not subject to an apportioned tax in Vermont, *is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State.* (Footnote omitted; Emphasis added; 100 S.Ct. 1223 at 1232)

Further, this Court noted in *Mobil*:

> In the absence of any proof of discrete business enterprise, Vermont was entitled to conclude that the dividend income's foreign source did not destroy the requisite nexus with in-state activities.'

The language in the above quotes demonstrates that the *Mobil* court was addressing the question of the relationship of

the stock investments to the unitary business operations of the taxpayer. In fact, this is the only relevant due process question decided in *Mobil.*

This conclusion is supported by the cases relied upon in *Mobil* in support of the "linchpin of apportionability" statement: *Butler Bros. v. McColgan, supra,* 315 U.S. 501 (1942); *Ford Motor Co. v. Beauchamp,* 308 U.S. 331 (1939); *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978); *Bass, Ratcliff & Gretten, Ltd. v. State Tax Comm'n.,* 266 U.S. 271 (1924); and *Underwood Typewriter Co. v. Chamberlain,* 245 U.S. 113 (1920). All of these cases, except *Beauchamp,* were cases which upheld the apportionability of the entire net income of a single corporate entity based on the unitary operations of the single entity. *Beauchamp* upheld the apportionment of the unitary value of Ford Motor Co. to Texas for net worth franchise tax purposes against the contention that the apportioned value grossly exceeded the value of Ford's Texas assets. In all of these cases, the court sustained apportionment of the entire income or value of a single enterprise since it was not shown (1) that any of the income or value was disassociated from the taxpayer's unitary business; or (2) that the apportionment reached extraterritorial values or income.

The *Mobil* court's disposition of the commerce clause issue also refutes Woolworth's due process argument as to apportionability of stock investment income. In disposing of the commerce clause argument of Mobil, this court was concerned with the argument that dividends should be allocated exclusively to the commercial domicile. In rejecting this argument, it held that dividends are subject to apportionment

> *** when the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to the benefits and privileges conferred by several states. These are circumstances in which apportionment is ordinarily the accepted method. (100 S.Ct. at 1236)

Here, there is no question that this Court was concerned with the relationship of the dividend income to the unitary business of a single corporation.

Incongruous tax results follow if the due process clause precludes the apportionability of dividends in circumstances where the commerce clause permits and indeed may require it. It is thus necessary to construe both clauses to produce a harmonious result.

When this is done, *Mobil* clearly supports the apportionment of income from intangibles if associated with the taxpayer's unitary business.

For due process purposes, the controlling question is whether stock investments, giving rise to dividends, are made in connection with or are in some way related to the unitary business of the recipient.

C. To condition the constitutionality of inclusion of income from stock investments upon a finding that the investments are in corporations which conduct a unitary business with the investor is illogical and should not be read into Mobil.

Reg. IV.1 (c) (4) of the Commission UDITPA regulations sets forth the following examples of apportionable dividend income under UDITPA:

> Example (i.): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

These examples are obvious illustrations of investments in stocks made for a purpose clearly associated with the taxpayer's unitary business operations. An investment in stock for this purpose is further illustrated by the following hypothetical example:

Assume that Corporation X conducts a business which requires the use of substantial amounts of electrical energy and it desires to locate a plant in an area where the local electric utility does not have the existing capacity to furnish Corporation X with the needed energy. Assume further that Corporation X agrees with the local utility to supply it with capital to expand the

utility's electrical energy capacity and purchases a minority stock interest in the utility for this purpose.

Under this example, it is clear that the stock was acquired for an essential business purpose directly associated with the business of Corporation X. It is inconceivable, under these facts, that the dividends from this stock, which represent at least in part Corporation X's deductible energy costs, cannot be apportioned for lack of a due process connection with Corporation X's business. Under this example, in a due process constitutional sense, why should the apportionability result be any different than if Corporation X had acquired a controlling interest in the local utility or formed its own utility in which it owned a controlling interest? We can conceive no difference.

The foregoing examples are not constitutionally distinguishable from Mobil's investment in ARAMCO stock which was held apportionable in *Mobil.* In each instance, the controlling question is the relationship of the stock investments to the taxpayer's trade or business operations in the taxing state. If there is a relationship, due process is satisfied.

Obviously, apart from the unitary ties between the business of a payee corporation and that of payor corporations, there can exist a relationship between stock investments and the business of the payee corporation which is sufficient to justify the apportionment of dividend income.

The key question as to apportionability under due process limitations is: "Is the income from investments related to or made in furtherance of the unitary trade or business of the taxpayer?" Framing the due process issue in this manner does not mean that the relationship of the business of the payor to the business of the payee taxpayer is irrelevant in determining whether the income from stock investments is includable in apportionable income. It simply means that it is not controlling. A taxpayer might make a stock investment to obtain a market

for its product or for a source of supplies.[10] Such considerations are relevant, however, only to determine the relationship of an investment to the business of the taxpayer. Other considerations are equally important for this purpose.

The decisions of the Supreme Court, including those relied on in *Mobil*, support this position. See, e.g., *Adams Express, supra; Bass, Ratcliff & Gretten v. State Tax Comm'n*, 266 U.S. 271 (1924); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911); *Underwood Typewriter Co. v. Chamberlain*, 245 U.S. 113 (1920); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931); *Moorman Mfg. Co. v. Bair, supra; Exxon Corp. v. Wisconsin Dept. of Revenue*, ____ U.S. ____, 100 S.Ct. 2109 (1980); and *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939).

All of these Supreme Court apportionment cases dealt with the unity of a single corporation; they upheld the apportionment of the entire property, values or income attributable to or arising in connection with the operations of a single unitary corporate entity. The same is true concerning many state income tax cases which have applied the unitary concept in determining the apportionability of income from intangibles.[11]

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[10] This is illustrated by Mobil's ownership of 10% of the stock in ARAMCO. ARAMCO constitutes a source of supply for crude oil for Mobil represented by its 10% ownership of the stock of ARAMCO. It also may be illustrated by Mobil's investments in public utility stock if such investments are made to obtain sources of power for Mobil's petroleum operations.

[11] See, e.g., *International Harvester v. Department of Taxation*, 322 U.S. 435 (1944); *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940); *Montgomery Ward & Co. v. Commissioner of Taxation*, 276 Minn. 479, 151 N.W.2d 294 (1967); *Great Lakes Pipeline Co. v. Commissioner of Taxation*, 272 Minn. 403, 138 N.W.2d 612 (1965), *app. dism'd* 384 U.S. 718 (1966); *F. W. Woolworth Co. v. Director of Division of Taxation*, 45 N.J.

There is nothing in *Mobil* which conflicts with the holdings in these cases.

Mobil did not distinguish dividends from other income for constitutional purposes. Therefore, the same considerations were applied there to determine the apportionability of dividend income as were applied to determine the apportionability of any other class of income, i.e., whether the income is derived from investments or activities related to the taxpayer's own unitary business.

D. Woolworth has raised no substantial federal question by arguing that the inclusion of "grossed up" dividends entitles it to relief from the UDITPA apportionment formula other than the relief given by the state of New Mexico.

While Woolworth has contended in the proceedings below that the inclusion of dividends in apportionable income entitles it to relief under the provisions of UDITPA, it neither (1) presented to the appellee any specific proposal for relief as

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Footnote 11. cont.

466, 213 A.2d 1 (1965); *Gulf Oil Corp. v. Morrison*, 120 Vt 324, 141 A.2d 671 (1958); *F. W. Woolworth Co. v. Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972); *Sperry & Hutchinson Co. v. Department of Revenue*, 270 Or.329, 527 P.2d 729 (1974); *Appeal of W. J. Voit Rubber Co., May, 1947 C.C.H. Cal Tax Rep. para 202-435; In Re Goodyear Tire & Rubber Co. Corporate Income Tax 1966, 1967, 1968*, 133 Vt. 132, 335 A.2d 310 (1975); *Albany International Corp. v. Halperin*, 388 A.2d 901 (Me. 1978); *Champion International Corp. v. Bureau of Revenue*, 88 N.M. 411, 54 P.2d 1330 (1975); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal.2d 214, 238 P.2d 569 (1951), *app. dismissed for want of a substantial federal question*, 334 U.S. 939 (9152); *Qualls v. Montgomery Ward*, 266 Ark. 207, 585 S.W.2d 18 (1979); *Montana Department of Revenue v. American Smelting and Refining Co.*, ___ *Mont.* ___, 567 P.2d 901 (1977), *app. dismissed*, 434 U.S. 104 (1978); *W. R. Grace & Co., v. Commissioner of Revenue*, ___ *Mass.* ___, 393 N.E.2d 330 (1979).

provided for under Section 18 of UDITPA [12] nor (2) submitted any facts to establish that the formula, as applied to it by the appellee, produced any unreasonable result or taxed any extra-territorial values or income.

It is therefore clear that, under controlling decisions of this Court, Woolworth is entitled to no apportionment relief in addition to that granted to it by the appellee.

The mere fact that dividends are included in apportionable income and that UDITPA apportions a taxpayer's total apportionable income by reference to a taxpayer's tangible property, payroll and sales does not *per se* invalidate an apportionment formula. Woolworth must still show by clear and cogent evidence that the apportionment formula is invalid. *Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942); *Norfolk & Western R. Co. v. North Carolina*, 297 U.S. 682, 688 (1936); *Norfolk & Western R. Co. v. Tax Commission*, 390 U.S. 317, 326 (1968).

E. The inclusion of "gross-up" in net income for state income tax purposes does not raise any federal question.

Woolworth's "gross-up" dividend argument is based on the premise that it is entitled constitutionally to exclude from a

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[12] This section reads:

"If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

state's income tax base an amount represented by the "gross-up" because it is improperly included in "net income" in a true economic sense even though it is included in federal taxable income.

At first blush, the "gross-up" issue would appear to present a simple, straightforward question, i.e., whether this particular item can constitutionally be included in a state's tax base prior to apportionment because it finds its way into "federal taxable income" by the application of a legal fiction. However, the question is much deeper than this. This is illustrated by the cases of *Dow Chemical Co. v. Commissioner of Revenue*, 391 N.E.2d 253 (Mass. 1979) and *Caterpillar Tractor Co. v. Lenckos*, ____ Ill. ____, 417 N.E.2d 1343 (1981) where the taxpayers made other elections for federal tax purposes which increased "federal taxable income" or where "federal taxable income" was argued to contain items that were not really net income to the taxpayer. In short, if the states cannot constitutionally rely on "federal taxable income," Pandora's box is open as to what is constitutionally includable *as to a whole host of items* which may find their way into a determination of "federal taxable income" and which may not be justified in any true business or economic sense. Furthermore, "federal taxable income" becomes a meaningless concept for state income tax purposes and those states relying on this tax base would be required to abandon it. In a constitutional sense, then, irrespective of how "gross-up" is characterized, the controlling question is whether a state can constitutionally rely on "federal taxable income" for imposition of state income taxes even though it, an abstract concept, contains elements of income and deductions, which standing alone, may not be rationally justified. Furthermore, such reliance is a two-way sword. For example, New Mexico, by reliance on "federal taxable income," has automatically granted Woolworth an 85% to 100% dividend deduction for its domestic dividends. For aught that appears

in the record, this deduction – justified solely for New Mexico income tax purposes because of its reliance on "federal taxable income" – may well exceed the "gross-up" in question.

In substance, then, this Court is requested to declare invalid all state income tax laws which use "federal taxable income" as a starting point to determine "net income" for state income tax purposes.

However, it is axiomatic that a state has a wide latitude in defining a tax base – net income or otherwise – for state tax purposes.

Based on the foregoing, there is little merit to Woolworth's "gross-up" constitutional argument. This is demonstrated by the fact that no constitutional issue has been raised in other "gross-up" and comparable cases and even here, Woolworth is asking for alternative forms of relief as to this question.

CONCLUSION

For the reasons herein stated, this Court should dismiss the appeal for lack of a substantial federal question or affirm the judgment of the New Mexico Supreme Court.

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CERTIFICATE OF SERVICE

I hereby certify that on the _____ day of May, 1981, I, Sarah E. Bennett, a member of the bar of the Supreme Court, caused to be mailed, postage prepaid, three copies of the foregoing Brief of Amicus Curiae to George W. Beatty and William L. Goldman, Counsel for the Appellant, at 1200 - 18th Street, NW, Washington, D.C. 20036 and to Michael D. Bray, at 919 Third Avenue, New York, New York 10022. I further certify that all parties required to be served have been served.

SARAH E. BENNETT
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No. 80-1745

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLANT

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QUESTIONS PRESENTED

1. Whether, under the "unitary business" test set forth by this Court in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), New Mexico's inclusion in appellant's apportionable business income of dividends paid to appellant by functionally independent foreign subsidiaries contravenes the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States.

2. Whether New Mexico's inclusion in appellant's apportionable business income of a "gross-up" amount equal to the "deemed paid" foreign tax credit allowed by the Federal Government with respect to the foregoing dividends contravenes the Due Process Clause.

3. Alternatively, whether New Mexico's inclusion of the dividends and "gross-up" in appellant's apportionable business income, without a correlative adjustment in the apportionment factors, contravenes the Due Process Clause.

4. Alternatively, whether New Mexico's inclusion of the dividends and "gross-up" in appellant's apportionable business income, without a correlative adjustment in the apportionment factors, contravenes the Foreign Commerce Clause of Article I, Section 8 of the Constitution.

SUBSIDIARIES (OTHER THAN WHOLLY OWNED SUBSIDIARIES) AND AFFILIATES OF F. W. WOOLWORTH CO., APPELLANT[1]

F. W. Woolworth public limited company (English subsidiary)[2]

F. W. Woolworth Co., S.A. de C.V. (Mexican affiliate)[3]

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[1] This list is provided pursuant to Rule 28.1 of the Rules of this Court.

[2] This company is the English subsidiary involved in this appeal. Its name was changed in 1981 from F. W. Woolworth and Co., Limited to the present name.

[3] This company is the Mexican corporation involved in this appeal. During the taxable year at issue it was wholly owned, but 51% of its stock was sold to Mexican nationals in 1981.

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No. 80-1745

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLANT

OPINIONS BELOW

The opinion of the Supreme Court of the State of New Mexico (the "New Mexico Supreme Court") is reported as *Taxation & Revenue Dept., etc.* v. *F. W. Woolworth,* 95 N.M. 519, 624 P.2d 28 (1981). The opinion of the Court of Appeals of New Mexico (the "New Mexico Court of Appeals") is reported as *F. W. Woolworth* v. *Bureau of Revenue of N.M.,* 95 N.M. 542, 624 P.2d 51 (Ct.App. 1979). Included as Appendix A to the Jurisdictional Statement[1]

[1] The Jurisdictional Statement filed in this case contains seven appendices, herein referred to as "J.S.App.A" through "J.S. App.G." The pages in the seven appendices are consecutively numbered. Where appropriate, references to these appendices will be followed by a page number indicating the location of the cited material in the appendices as a whole.

The separately bound joint appendix filed by the parties to this appeal will be referred to as the "J.A."

The four appendices attached to this brief will be referred to as "App.A, *infra*" through "App.D, *infra.*"

are copies of those opinions (J.S.App.A 1a-22a and 23a-29a, respectively) and the unreported Decision and Order of the Director of the Revenue Division of the Taxation and Revenue Department of the State of New Mexico (referred to herein as the "Revenue Department" or appellee) (J.S.App.A 30a-38a).

JURISDICTION

On January 19, 1981, the New Mexico Supreme Court rendered its opinion upholding the constitutionality of the New Mexico taxing statute as applied to appellant. This appeal was docketed within 90 days of that date on April 17, 1981. This Court noted probable jurisdiction on October 5, 1981. (J.A. 71a) This Court has jurisdiction under 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Commerce Clause (Art. I, § 8, cl. 3):

> Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

Due Process Clause (Amend. XIV, § 1):

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law;

Sections 7-2-2(S), 7-2-2(T), 7-4-2(A), 7-4-3, 7-4-5, 7-4-8, 7-4-10, and 7-4-11 of the New Mexico Statutes 1978, Annotated ("N.M.S.A. 1978") are set forth in J.S.App.D.[2]

Sections 212(2) and 215(1) of the Income Tax Act of Canada; EStG Articles 20(1) No. 1, 43(1) No. 1, 44(1),

[2] The statutory references are to the New Mexico statute as recodified in 1978 since these are the statutory provisions referred to in the opinion of the New Mexico Supreme Court. The substantive provisions, however, are the same as those in effect during the period in issue and were not amended or changed as part of the recodification.

49(1) No. 5; and KStG Article 50(2) No. 2 of Germany; and Articles 60 V, 61, 73 I, and 74 of the Income Tax Law of Mexico, as in effect during the year in issue, are set forth in App. A, *infra*.

Sections 78, 901(a), and 902(a) of the Internal Revenue Code of 1954, as amended, are set forth in App. B, *infra*.

STATEMENT OF THE CASE

F. W. Woolworth Co., the appellant, is a New York corporation engaged in the retail business throughout the United States, Puerto Rico, and the Virgin Islands. It purchases a variety of consumer items (including dry goods, hardware, appliances, candy, and some packaged food) and sells them at retail through Woolworth and Woolco stores. Most of the stores also serve fountain items and meals. (J.S.App.A 2a, 32a) The foregoing business activities are hereinafter referred to as appellant's "Unitary Business."

During its fiscal year in issue, which ended January 31, 1977 ("fiscal 1977"), appellant received $39,881,161 in dividends from four of its foreign subsidiaries: F. W. Woolworth and Co., Limited, a 52.7% owned English subsidiary; F. W. Woolworth Co. GmbH, a wholly owned German subsidiary; F. W. Woolworth, Limited, a wholly owned Canadian subsidiary; and F. W. Woolworth Co., S.A. de C.V., a wholly owned Mexican subsidiary. (J.S. App.A 1a, 26a, 33a, 35a; J.A. 61a, Sch. C, line 5)

During fiscal 1977, these four subsidiaries were in the same general type of business as appellant, operating retail stores in their respective countries. (J.S.App.A 33a) The operation of a multi-store retail business, such as that carried on by each of appellant's foreign subsidiaries, entails the following essential functions: selecting sites for stores, selecting the type and quantity of merchandise to be sold to the public, inventory purchasing, advertising, funding of business operations, accounting and cash control, and personnel selection and training. (J.A. 10a-11a)

Appellant's foreign subsidiaries did no business in New Mexico or elsewhere in the United States. In addition, as the record shows, each subsidiary's retail business was functionally separate and distinct from appellant's retail business in the United States and from the retail businesses conducted by the other foreign subsidiaries.[3] Each subsidiary made and carried out its own decisions with respect to:

1. *Site selection:* Each subsidiary chose its own store sites, without consulting appellant. (J.A. 11a-12a, 18a, 26a, 30a; J.S.App.A 33a)

2. *Merchandise selection:* Each subsidiary sold a different mix of merchandise in order to respond to local tastes and needs in its own country. For example, in England, many of the stores had a restaurant and cafeteria as well as a supermarket section where food was sold. In Germany, there was an emphasis on soft goods (such as dresses, coats, and other clothing) and there were no food selling operations. (J.A. 12a-13a, 18a, 21a; J.S.App.A 33a)

3. *Inventory purchasing:* Each subsidiary purchased its inventory separately and there was no central buying office. Although the New Mexico Supreme Court stated otherwise, the record shows that there were no intercompany sales of inventory between appellant and the foreign subsidiaries. In large part, each subsidiary made its inventory purchases in its own country. However, even where appellant and its foreign subsidiaries purchased inventory items in the same countries abroad (*e.g.*, the Orient), the purchasing was done independently. (J.A. 13a-14a, 18a, 25a, 29a, 42a-45a; J.S.App. A 33a-34a)

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[3] The factual statements which follow are based on the testimony (J.A. 9a-54a) and on the findings of the Revenue Department's Hearing Examiner (J.S.App.A 30a-36a). In describing the evidence cited by appellee, the New Mexico Supreme Court made several factual statements (J.S.App.A 8a-9a) which are not supported by the record. These statements are identified and discussed at pp. 21-24, *infra*.

4. *Advertising:* Each foreign subsidiary handled its own advertising. There was very little advertising in Germany, whereas there was a very high degree of local advertising in England. (J.A. 12a, 13a, 14a-15a, 18a, 29a; J.S.App.A 34a)

5. *Funding of business operations:* Each subsidiary was responsible for funding its day-to-day business operations, although major financial decisions were approved by appellant. During the year in issue and for some time prior thereto, appellant provided no financial support to the subsidiaries except that some of the dividends which the German subsidiary declared to reduce its own German taxes were reinvested in the German subsidiary. (J.A. 16a-18a, 26a, 28a, 29a, 30a-33a, 45a-46a, 51a-52a; J.S.App.A 27a-28a, 35a)

6. *Accounting and cash control:* Each subsidiary handled these functions autonomously. Each had a complete accounting department and financial staff. (J.A. 12a, 14a, 18a; J.S.App.A 34a)

7. *Personnel selection and training:* Appellant did not have a personnel training school for its foreign subsidiaries. Nor did appellant rotate or exchange personnel with its subsidiaries. Each subsidiary developed its own managers. The Chief Executive Officers of the English and German subsidiaries were local nationals. In fact, none of the officers of those subsidiaries was a current or former employee of appellant. (J.A. 13a, 15a-16a, 18a, 24a-25a, 50a; J.S. App.A 34a)

Several of appellant's 15 to 18 Directors served on the Board of Directors of the Canadian, English, or Mexican subsidiaries. (J.A. 23a-24a, 29a, 39a, 40a-41a; J.S.App.A 34a) The Chief Executive Officers of the subsidiaries came to New York "on a rare occasion, once a year," and appellant's Chief Executive Officer traveled to Canada, England, or Germany "on occasion." (J.A. 34a-35a; J.S.App.A 34a) Other officers of appellant may have traveled there sporadically. (J.A. 35a) Appellant had a vice president who performed a liaison function with the smaller foreign subsidiaries in Mexico and Spain and may have contacted the other foreign subsidiaries from time to time. (J.A. 50a;

J.S.App.A 34a) In addition, there was communication of an unspecified nature by telephone, correspondence, and teletype. (J.A. 34a-35a; J.S.App.A 34a) However, there was no ongoing day-to-day communication or exchange of information at the operating level concerning market conditions, pricing of merchandise, or other operational matters. (J.A. 36a-37a) The managers of the subsidiaries never got together to discuss overall operations, planning for future programs, or future expansion. (J.A. 35a) Nor did appellant have a department or section devoted to overseeing the operations of the foreign subsidiaries. (J.A. 50a; J.S.App.A 34a)

In fiscal 1977, appellant realized an exchange gain of $1,595,551 from a hedging transaction in British pounds. Appellant entered into this transaction in order to protect the dollar value of a declared dividend which appellant expected to receive from its English subsidiary in British pounds. (J.A. 52a-54a, 57a, line 17)

On its federal income tax return for fiscal 1977, appellant elected, pursuant to sections 901(a) and 902(a) of the Internal Revenue Code (the "Code"), to claim "deemed paid" foreign tax credits for foreign taxes actually paid by the foreign subsidiaries with respect to the earnings they distributed as dividends to appellant. Under section 78 of the Code, appellant was required to treat the $25,502,782 amount of such deemed paid credits as "grossed-up" dividend income.[4] (J.A. 61a, Sch. C, line 7; J.A. 63a, line 10(a))

In filing its New Mexico tax return for fiscal 1977, appellant apportioned its operating business income between

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[4] Sections 901(a), 902(a), and 78 of the Code are set forth in App. B, *infra*. If a foreign subsidiary of a United States parent earns $100, pays foreign tax of $40, and pays a dividend of $30 out of its after-tax profits of $60, the deemed paid foreign tax credit of the parent under section 902(a) is 30/60 × $40, or $20. The parent includes $50 in dividend income (*i.e.*, the actual dividend of $30 plus $20 of "gross-up") and claims a foreign tax credit of $20 against the federal income tax on this income.

sources within and without New Mexico on the basis of the three-factor formula prescribed by section 7-4-10, N.M.S.A. 1978. This three-factor formula apportioned to New Mexico that fraction of appellant's total "business income" which was the average of the ratios of appellant's tangible property, payroll, and sales in New Mexico to its total tangible property, payroll, and sales everywhere. (See J.S.App.D 46a) Appellant did not include its dividends from its foreign subsidiaries, the related "gross-up" amount, or its exchange gain in its apportionable business income. Appellant's apportionable business income and New Mexico taxable income for fiscal 1977 were reported as $18,274,068 and $84,622, respectively. (J.A. 57a)

On audit, the Revenue Department determined that (1) all of appellant's dividends, gross-up, and foreign exchange gain were includable in apportionable business income, and (2) the inclusion of these items in apportionable business income did not warrant any correlative adjustment in appellant's New Mexico apportionment factors to reflect the property, payroll, and sales of the subsidiaries paying the dividends.[5] Because of the large amounts involved, this adjustment increased appellant's New Mexico taxable income from $84,622 to $401,518 for fiscal 1977. (J.A. 69a)

Relying on both statutory and constitutional grounds, appellant challenged the inclusion of the dividends, gross-up, and foreign exchange gain in apportionable business income. Alternatively, appellant challenged the absence of correlative factor modification. The New Mexico Court of Appeals upheld appellant's primary statutory arguments concerning the measure of apportionable business income (thereby reversing the decision of the Revenue Department) without reaching the constitutional issues. (J.S. App.A 23a-29a) This decision, in turn, was reversed by the

[5] The Revenue Department did add the additional income to the denominator of the sales factor, thereby reducing the apportionment percentage from .463073 of 1% (J.A. 57a) to .458335 of 1% (J.A. 69a).

New Mexico Supreme Court which rejected appellant's statutory and constitutional arguments. (J.S.App.A 1a-22a)

SUMMARY OF ARGUMENT

1. *Exclusion of Dividends from Apportionable Income:* Prior decisions of this Court permit a nondomiciliary State to use a formulary apportionment method to determine the income tax liability of a corporation doing business both inside and outside the State. However, this approach is permissible only if and to the extent that the income being apportioned is derived from a "unitary business" in which the activities being conducted outside the taxing State are functionally integrated with the activities being conducted inside the State.

In such cases, the State is permitted to tax a fairly determined fractional part of the total income earned by the enterprise as a whole, because there may be no other way of identifying and separately accounting for the profits generated by the activities within the taxing State. However, where there are operations outside the taxing State which are functionally discrete, and can therefore be separately accounted for, apportionment with respect to those operations is neither necessary nor appropriate. If the out-of-state activities do not contribute in some meaningful way to the production of income within the State, the State has no legitimate interest in taxing *any* portion of the income earned from those out-of-state activities.

In *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the Court made it clear that the foregoing "functional integration" test applies to dividends which a corporation doing business within the State receives from other corporations operating exclusively outside the State. Under *Mobil*, the dividends may be included in the apportionable income of the recipient only if the out-of-state activities of the payor are so closely related, in a functional sense, to the in-state activities of the recipient that all of those activities constitute a single "unitary business."

In the present case, the dividends which appellant received from its subsidiaries operating retail businesses abroad were not properly includable in appellant's apportionable income for New Mexico tax purposes because all four subsidiaries were independently managed, separately operated, free-standing concerns. Each foreign subsidiary selected its own store sites, determined its own merchandising policies, purchased its own inventory, did its own advertising, handled its own accounting and cash control, and selected and trained its own personnel. By reason of significant geographical and cultural differences, the merchandising operations in each foreign country were necessarily different and distinct. Although the New Mexico Supreme Court stated that there was "some flow back and forth of goods," the record shows that, in actual fact, there were *no* intercompany sales of inventory between appellant and any of the subsidiaries. The Chief Executive Officers of the major subsidiaries were local nationals. Indeed, none of the officers of the two major subsidiaries in England and Germany had *ever* been an officer, *or even an employee,* of appellant.

Thus, in all respects, the retail operations of the foreign subsidiaries were totally separate and distinct from appellant's retail operations in the United States. The profits earned by the foreign subsidiaries and distributed to appellant had nothing to do with appellant's New Mexico activities and should therefore not be included in the New Mexico tax calculation. Appellant's exchange gain from hedging one of the dividends stands on the same footing.

2. *Exclusion of Gross-Up from Apportionable Income:* For federal income tax purposes, appellant claimed a "deemed paid" foreign tax credit for foreign taxes paid by the subsidiaries with respect to the profits they distributed to appellant as dividends. As a mechanical means of arriving at the appropriate overall tax rate in such cases, federal law provides that an amount equal to the deemed paid foreign taxes being credited must be "treated" as additional "gross-up" income of the shareholder claiming

the credit. Thus, gross-up is not income in any conventional sense, but is, instead, an admittedly "fictional" item which is used to *reduce* the tax benefit that a federal taxpayer can derive from claiming a deemed paid foreign tax credit. The inclusion of gross-up in apportionable income at the state level, without any recognition of the larger offsetting foreign tax credit that creates the gross-up under federal law, inevitably contravenes the Due Process Clause. There is no reason or justification for New Mexico to tax *any* portion of a computational item on appellant's federal tax return where, as here, that item is admittedly "fictional" and has absolutely nothing to do with appellant's operations in New Mexico.

3. *Modification of Apportionment Factors:* If this Court nevertheless holds that any or all of the foregoing dividends, exchange gain, and gross-up amounts may constitutionally be included in appellant's apportionable business income, the New Mexico tax will still contravene the Due Process Clause, and also the Foreign Commerce Clause, unless New Mexico adjusts its regular apportionment formula to reflect the foreign property, payroll, and sales which generated the profits being included in appellant's apportionable business income base.

In *Mobil*, this Court held that the apportionability of income the taxpayer receives from unitary business activities should not be affected by whether the income is received in the form of divisional profits or dividends from legally separate entities. This Court stated (445 U.S. at 441) that transforming divisional profits into dividends "works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives."

If the income which appellant received in the form of dividends from subsidiaries operating outside New Mexico had constituted profits of unitary divisions being operated outside New Mexico, there is no question that the out-of-state property, payroll, and sales of the divisions would have been taken into account in the apportionment factors.

New Mexico's failure to reduce the apportionment fraction to reflect out-of-state property, payroll, and sales of the dividend-paying subsidiaries violates the Due Process Clause because it inevitably overstates the portion of appellant's total income which is attributable to its New Mexico property, payroll, and sales.

New Mexico's failure to adjust the apportionment factors also violates the Foreign Commerce Clause by permitting New Mexico to impose a direct tax on foreign-source investment income that has already been taxed abroad. In accordance with international custom, the laws and treaties of this Nation explicitly provide for the avoidance of such double taxation at the federal level. Consequently, New Mexico's failure to use some mechanism that will avoid double taxation at the state level prevents this Nation from speaking with one voice in matters affecting commercial relations with foreign countries.

ARGUMENT

I. UNDER *MOBIL*, NEW MEXICO'S INCLUSION OF THE DIVIDENDS AND RELATED EXCHANGE GAIN IN APPELLANT'S APPORTIONABLE BUSINESS INCOME CONTRAVENES THE DUE PROCESS CLAUSE.

As described above, appellant's "Unitary Business" involves the operation of retail stores throughout the United States, Puerto Rico, and the Virgin Islands. Because it operates retail stores in New Mexico, appellant agrees that it is subject to tax in New Mexico on that portion of the income from its Unitary Business which is properly attributable to its New Mexico activities. Appellant also agrees that New Mexico may use a formulary apportionment method (rather than separate accounting) to determine the portion of appellant's Unitary Business income which is properly attributable to its New Mexico activities. *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (hereinafter "*Mobil*"); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978). However, appellant submits that, under the Due Process Clause, the dividends and

related exchange gain at issue here may not be included in the Unitary Business income which is subject to apportionment.

A. This Court's Decision in *Mobil*.

The threshold issue in *Mobil* was whether, under the Due Process Clause, a nondomiciliary State (Vermont) could constitutionally tax (by inclusion in apportionable income) certain dividends received by a resident corporation (Mobil) from nonresident payor corporations having no contact with the taxing State.[6] Although the record in the *Mobil* case failed to provide much detail, this Court made the key finding that (445 U.S. at 435):

> [I]t is apparent, from perusal of such documents in the record as appellant's corporate reports for the years in question, that many of these subsidiaries and affiliates, including the principal contributors to appellant's dividend income, engage in business activities that form part of Mobil's integrated petroleum enterprise. Indeed, although appellant is unwilling to concede the legal conclusion that these activities form part of a "unitary business," see Reply Brief for Appellant 2, n.1, it has offered no evidence that would undermine the conclusion that most, if not all, of its subsidiaries and affiliates contribute to appellant's worldwide petroleum enterprise.

On this basis, this Court upheld Vermont's power to include the dividends paid by these subsidiaries and affiliates in Mobil's apportionable income, stating (445 U.S. at 439):

> [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle. In

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[6] As used hereinafter, the term "resident" corporation means a corporation which is doing business within the taxing State, but is organized under the laws of some other State and has its headquarters or commercial domicile in some other State. Since appellant has its legal and commercial domicile in New York (J.S.App. A 2a, 30a) and does business in New Mexico, appellant is a resident of New Mexico.

accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. *Bass, Ratcliff & Gretton* [266 U.S. 271 (1924)] forecloses the contention that the foreign source of the dividend income alone suffices for this purpose. Moreover, appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from its petroleum sales activities in Vermont. Indeed, all indications in the record are to the contrary, since it appears that these foreign activities are part of appellant's integrated petroleum enterprise. [Footnote deleted.]

This Court also stressed that the form of business organization should have no impact on the outcome, stating (445 U.S. at 440-441):

Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.

Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives. [Footnote deleted.]

In addition, at a later point in the opinion, the Court explicitly confirmed that it had based its decision on the relationship between Mobil's activities and those of the payor corporations, stating (445 U.S. at 442):

> Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. We need not decide, however, whether Vermont's tax statute would reach extraterritorial values in an instance of that kind. Cf. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S., at 121. Mobil has failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates that would raise the question of nonapportionability. [Citations and footnote deleted.]

B. Under the "Unitary Business" Test of *Mobil*, the Issue Is Whether the Activities of the Dividend-Paying Corporation and Those of the Recipient in the Taxing State Are Part of a Single Functionally Integrated Business.

The foregoing quotations from the Court's opinion make it plain that the unitary business test adopted in *Mobil* is whether the "underlying activity"—that is, the *business activity of the dividend-paying corporation*—is part of a "functionally integrated enterprise" being conducted, in part, by the recipient corporation in the taxing State. In other words, the test is whether the activities of the dividend-paying corporation and the activities of the recipient in the taxing State are part of the same functionally integrated, unitary business.

The reason for this "functional integration" requirement becomes obvious when one bears in mind the purpose of formulary apportionment. As this Court has recognized on many occasions, the need for formulary apportionment arises in cases such as this because of (1) the constitutional requirement that a nondomiciliary State tax only the income from the resident corporation's in-state activities, and

(2) the difficulty in determining such income where the resident corporation conducts an integrated, unitary business both within and without the taxing State. See, *e.g.*, *Exxon Corp.* v. *Wisconsin Dept. of Revenue, supra* (integrated petroleum business); *Mobil,* (integrated petroleum business); *Moorman Mfg. Co.* v. *Bair, supra* (integrated manufacture and sale of animal feeds); *Butler Bros.* v. *McColgan,* 315 U.S. 501 (1942) (integrated wholesale business); *Bass, Ratcliff & Gretton* v. *State Tax Commission,* 266 U.S. 271 (1924) (integrated manufacture and sale of ale); and *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters). In such cases, the State is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121. But such allocation is "impossible" only where the in-state and out-of-state activities are so closely tied together that the income is earned by the entire enterprise as a unit; in such cases, as this Court noted in *Mobil* (445 U.S. at 438):

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. *Butler Bros.* v. *McColgan,* 315 U.S., at 508-509. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source."

By comparison, where two activities of a corporation, or the activities of a parent corporation and its subsidiary, are functionally discrete, separate accounting will suffice to determine the income from each separate activity and there is no need for apportionment.

The foregoing analysis has been uniformly recognized by this Court in its apportionment decisions. For example, in *Adams Express Co.* v. *Ohio State Auditor,* 165 U.S. 194 (1896), the Court noted that unity of ownership alone was

insufficient to justify apportionment, stating (165 U.S. at 222):

> The same party may own a manufacturing establishment in one state and a store in another, and may make profit by operating the two, but the work of each is separate. The value of the factory in itself is not conditioned on that of the store, or *vice versa*, nor is the value of the goods manufactured and sold affected thereby. The connection between the two is merely accidental and growing out of the unity of ownership.

By comparison, where the store sells the products manufactured by the factory, the operations of the two become functionally integrated and apportionment is appropriate. Thus, in *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra*, this Court stated (266 U.S. at 282):

> So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places, —the process of manufacturing resulting in no profits until it ends in sales, —the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business.

Similarly, where, as here, a multi-store retail business is involved, apportionment may be appropriate if the operations (merchandise selection, inventory purchasing, advertising, and other similar functions) are conducted in an integrated fashion. In such a case, the integration would be "horizontal" rather than "vertical." See, *e.g., Butler Bros.* v. *McColgan, supra*, where wholesale stores in several States were operated in an integrated fashion by utilizing a central buying division, a central advertising division, and centralized executive management.

Thus, to qualify as a unitary business, the activities involved must constitute a *functionally integrated enterprise which earns its income as a unit or a whole*, thereby justifying apportionment. In accordance with this principle,

many of the cases involving dividend income have recognized that apportionability turns on the functional relationship between the activities of the payor and recipient corporations. In addition to *Mobil*, see also *F. W. Woolworth Co.* v. *State of Alaska, Department of Revenue* (Alaska Sup. Ct. Oct. 29, 1981); *Square D Co.* v. *Kentucky Board of Tax Appeals*, 415 S.W.2d 594 (Ky. 1967); *Gulf Oil Corp.* v. *Clayton*, 267 N.C. 15, 147 S.E.2d 522 (1966); *American Bakeries Co.* v. *Johnson*, 259 N.C. 419, 131 S.E. 2d 1 (1963); and *Marshall-Wells Co.* v. *Commissioner of Taxation*, 220 Minn. 458, 20 N.W.2d 92 (1945).

In the recent Alaska *Woolworth* case, which involved dividends appellant received from its foreign subsidiaries in 1972 through 1975, the Alaska Supreme Court expressly held that, under *Mobil*, the dividends could not be included in appellant's apportionable income unless "the business from which the dividends [were] derived" was "part of the unitary business being taxed. . . ." (Slip Op. 2) The case was remanded for a determination on this issue. Thereafter, the Alaska Department of Revenue filed a petition for rehearing conceding that appellant was "not conducting a unitary business with the foreign sibling corporations from which it received the dividends."

In *Square D Co.* v. *Kentucky Board of Tax Appeals, supra*, a parent corporation doing business in Kentucky received dividends from two wholly owned subsidiaries conducting the same type of business in Canada and Mexico. In recognition of the constitutional limitations on state taxation, the court concluded that the Kentucky statute should be construed to prevent Kentucky from including the dividends in the parent's apportionable income. In so holding, the court stated (415 S.W.2d at 602):

> No part of the . . . Canadian or Mexican incomes can be said to have been derived from Kentucky operations unless the apparently independent foreign activities were so integrated and interrelated with those in Kentucky that the separate sources cannot be reasonably and separately identified. We do not think this can be

> said of any of the dividend . . . income here in controversy.

Over the years, a number of other tests for determining the scope of a unitary business have been formulated by the courts.[7] In the present case, and in a prior New Jersey decision also involving the apportionment of appellant's dividend income, the state courts looked to the overall size and financial power which appellant derived from its ownership of the stock of the subsidiaries. See the decision below (J.S.App.A 18a-19a) and *F. W. Woolworth Co.* v. *Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965).

In the New Jersey case, the court stated (213 A.2d at 14):

> We know of no United States Supreme Court case holding or even intimating that . . . close functional integration [of the type involved in *Butler Bros.* v. *McColgan, supra*] is a *sine qua non* for a finding of a unitary enterprise. . . .

In *Mobil*, this Court stated (445 U.S. at 440) that dividends may be apportioned "[s]o long as . . . [they] reflect profits derived from a functionally integrated enterprise. . . ." Thus, it is obvious that the New Jersey court's decision—and other prior state court decisions like it—no longer have any vitality.

In its Motion to Dismiss, appellee states (pp. 4-5) that we are misreading *Mobil*, and asserts that attention must be focused on appellant's *own* activities to determine whether appellant's income-producing investments are sufficiently related to appellant's other business activities to form part of its Unitary Business. There may be situations, not considered in *Mobil* and not present here, in which it

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[7] See, *e.g.*, the cases discussed in Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 42, 45-52 (1960) and Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 Nat.Tax.J. 487, 496-501 (1968). See also *Mobil*, 445 U.S. at 439, n.14 and 443, n.17.

would be appropriate to focus only on the taxpayer's own activities, without regard to the underlying activities of the company paying the dividends.[8] But where, as here, there is no evidence suggesting that the taxpayer's business consists of, or necessarily involves, securities investments, there is no basis under *Mobil* for treating the dividend income as part of the taxpayer's unitary business income unless the underlying business activities generating that income are functionally integrated with the taxpayer's business activities. As we shall now show, that type of functional relationship does not exist in the present case.

C. Application of the *Mobil* "Functional Integration" Test to This Case.

Appellant has met its burden under *Mobil* by showing that the retail businesses of its foreign subsidiaries were functionally separate and distinct from appellant's own retail business activities in New Mexico and elsewhere in the United States. As described in greater detail in our statement of the case (pp. 4-6, *supra*), each subsidiary made and carried out its own decisions with respect to all of its essential operating functions (site selection of the stores, merchandise selection, inventory purchasing, advertising, funding of business operations, accounting and cash control, and personnel selection and training). None of these functions was centrally managed by appellant. Nor did any of the foreign subsidiaries conduct these functions in an integrated fashion with appellant or any of the other subsidiaries. (J.A. 12a-15a, 18a, 25a, 29a-30a, 35a, 48a)

As a consequence of operating its own separate retail business, each subsidiary conducted its business in a somewhat different manner, selling different merchandise, using different types of advertising, and using different person-

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[8] For example, if the taxpayer is a securities dealer or underwriter, it may be constitutionally permissible for a State to treat the taxpayer's dividend and interest income from securities held in inventory as apportionable business income.

nel. (J.S.App.A 33a-34a; J.A. 12a-15a, 18a, 21a) Each subsidiary also purchased its own inventory separately, generally in its own country. And even where appellant and its foreign subsidiaries purchased inventory items in the same countries, the purchasing by each corporation was done independently. (J.S.App.A 33a-34a; J.A. 13a-14a, 18a, 25a, 44a)

The facts here are in obvious contrast to the situation in *Butler Bros.* v. *McColgan, supra,* which involved "closely integrated" wholesale operations with a "central buying division," a "central advertising division," and "centralized management." See 315 U.S. at 504-505, 508-509. Under those circumstances, where the benefit of centralized functions contributed to the profitability of the business as a whole, this Court held that apportionment was a permissible method for determining the taxpayer's California taxable income. See also *Edison California Stores* v. *McColgan,* 30 Cal.2d 472, 183 P.2d 16, 18 (1947), where a multi-store retail operation conducted by an affiliated group of corporations was treated as a single, unitary business because all of the corporations used "[a] central management division, a central purchasing department, a central distributing department, a central store operations department, a central advertising department, and various other central administrative departments."

Here, however, as shown above, appellant and its foreign subsidiaries carried on their retail businesses separately and independently. The foreign operations had no functional connection with, and therefore contributed nothing to the efficiency or profitability of, appellant's Unitary Business, which was purely domestic. Appellant's English subsidiary earned all of its profits in England. Nothing that it did had any effect on the profitability of appellant's stores in New Mexico. The same was true of each of the other foreign subsidiaries. Therefore, there is no need or reason to take the income generated by the subsidiaries' foreign operations into account in determining the income attributable to appellant's New Mexico activities. The

profits earned by appellant's domestic Unitary Business and the profits earned by the subsidiaries' operations abroad can be accurately determined on a separate accounting basis because there were *no* intercompany sales of inventory or other business transactions between appellant and the subsidiaries, and no shared services, facilities, or activities which would make it difficult to determine the income of each corporation on a separate basis. Accordingly, there is no constitutional justification for including any part of the profits earned by the foreign operations in the New Mexico tax calculation.

In reaching the opposite conclusion, the New Mexico Supreme Court misstated several significant facts and relied on other factors which are not relevant. The principal erroneous or potentially misleading statements in the court's opinion are the following:

1. *Flow of goods:* In describing the evidence on which appellee was relying, the court stated that "There is some flow back and forth of goods. . . ." (J.S.App.A 9a) This statement is contrary to the record. On direct examination, appellant's witness, Mr. Feeley, was asked, "Are there any inter-company sales of inventory?" and he answered, "None." (J.A. 13a) On cross-examination, when asked whether the English subsidiary purchased goods from appellant, he confirmed that "They do not. . . ." (J.A. 44a) There is no other record reference to any intercompany inventory transactions involving appellant and the foreign subsidiaries.[9] Accordingly, the uncontradicted evidence of

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[9] When asked on cross-examination whether the foreign subsidiaries purchased any merchandise from three manufacturing subsidiaries of appellant, the witness responded, "I don't know . . . . It is inconceivable to me . . . that they would." (J.A. 43a; see also J.A. 42a) This is perfectly consistent with his unqualified statement on direct examination that there were no "inter-company sales of inventory." (J.A. 13a) That statement clearly related, in context, to possible intercompany sales involving appellant. (See J.A. 12a-14a.)

record shows that there was *no* "flow of goods" between appellant and the subsidiaries.

2. *Exchange of business information:* The New Mexico Supreme Court's recitation of the evidence states that "[t]here is a substantial exchange of business information . . . between the parent and its affiliates." (J.S.App.A 9a) In fact, despite the efforts of counsel for appellee to develop evidence which would have supported such a statement (J.A. 33a-37a), the record shows that:

a. The managers of the subsidiaries never got together to discuss overall operations, planning for future programs, or future expansion. (J.A. 35a)

b. Although appellant's personnel and the subsidiaries' personnel exchanged information "from time to time" (J.A. 36a), there was no ongoing day-to-day dialogue or exchange of information at the operating level concerning "purchasing, accounting, planning, advertising, merchandising, expansion or retraction from markets, personnel training, site selection." (J.A. 36a-37a)[10]

c. The chief executives of the foreign subsidiaries came to New York "on a rare occasion, once a year." (J.A. 34a)

d. Appellant's "Chief Executive Officer would on occasion travel to Canada, England, or to Germany to confer with the managers there." (J.A. 35a)

e. The "methods of communication" between appellant and the foreign subsidiaries included the telephone, correspondence, and teletype, but there was no testimony as to

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[10] After specifically asking whether there was a "definite exchange of information" with respect to these activities "in all levels" and receiving a response which was clearly going to be negative (J.A. 36a-37a), counsel for appellee interrupted, stating (J.A. 37a):

> Q. I see. It is not a day-to-day type of thing and he isn't telling them what to sell a given item for, I didn't mean that at all.
>
> I am talking about the bigger picture—the big picture I am talking about.

the frequency of their use or the nature of any communications. (J.A. 34a-35a)

Obviously there was some communication between appellant and its foreign subsidiaries. However, the New Mexico Supreme Court's statement that there was a "substantial exchange of business information" (J.S.App.A 9a) goes beyond the record and is misleading. The limited communications that emerge from the record afford no basis whatever for concluding that the subsidiaries' activities in their respective foreign countries were a "functionally integrated" part of appellant's Unitary Business activities.

3. *Flow of financial resources:* The New Mexico Supreme Court's recitation of the evidence states there was "some flow back and forth of . . . financial resources." (J.S.App.A 9a) This statement is not erroneous if it is only intended to refer to appellant's initial investment in the foreign subsidiaries, the relatively small loans which were made by appellant to the subsidiaries and repaid well before the year in issue, the reinvestments in the German subsidiary of dividends which were declared to reduce the German subsidiary's own taxes, and the dividends paid by the subsidiaries to appellant. (See J.A. 16a-18a, 28a, 30a-31a, 32a-33a, 45a-46a, 51a-52a) Such a "flow" of "financial resources" is perfectly consistent with any investment by a major shareholder in a corporation and is therefore irrelevant in determining whether the business activities of the shareholder and the corporation are functionally integrated.[11]

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[11] The New Mexico Supreme Court also stated that the dividends were placed in appellant's "general operating account" (J.S.App. A 19a), and emphasized this as pointing to functional integration. This argument proves too much. If it were correct, then all investment income could be included in apportionable business income and the discussion in *Mobil* of the "underlying activities" of the dividend-paying corporation would be meaningless. Moreover, even if use of the funds were relevant, the result here would not change. The record does not support the Hearing Examiner's finding that

However, considered by itself, the court's statement regarding a "flow" of financial "resources" might be more broadly construed, and it could therefore be misleading unless clarified as above.

4. *Oversight of the foreign subsidiaries:* The New Mexico Supreme Court's recitation of the evidence also states that appellant "has an international vice president that is responsible for overseeing its foreign subsidiaries. . . ." (J.S. App.A 8a) In fact, as found by the Hearing Examiner (J.S.App.A 34a), the vice president was only a "liaison man with the smaller foreign subsidiaries." This finding is based directly on the testimony. (J.A. 50a) The Hearing Examiner also found (J.S.App.A 34a) that "[t]he taxpayer has no department or section, as such, devoted to overseeing the foreign subsidiary operations." Insofar as the issue of control is concerned, appellant's activities were limited to the normal stewardship functions of a major corporate shareholder (*e.g.*, approval of major financial decisions, interlocking directors with some of the subsidiaries' Boards of Directors, and control over dividend payments).

In view of the foregoing, there can be no real dispute about the functional independence of appellant's foreign subsidiaries. Admittedly, appellant owned a controlling interest in each subsidiary and the subsidiaries were engaged in the same type of business as appellant. But in themselves, these factors do not establish the requisite functional integration and, therefore, they are insufficient to justify the apportionment of the dividends. *F. W. Woolworth Co.* v. *State of Alaska, Department of Revenue,*

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the dividends were (J.A.App.A 35a) "used for general corporate operating purposes." The testimony only showed that the dividends were placed in appellant's "general treasury." (J.A. 52a) Thus, the New Mexico Court of Appeals stated that it was more reasonable to regard the dividends of $39,881,161 as simply being passed on to appellant's shareholders, who received $39,986,308 in fiscal 1977. (J.S.App.A 27a; J.A. 61a, Sch. C, line 5; J.A. 65a, Sch. M-2, line 5)

supra; Square D Co. v. *Kentucky Board of Tax Appeals, supra; Gulf Oil Corp.* v. *Clayton, supra; American Bakeries Co.* v. *Johnson, supra.* See also *Adams Express Co.* v. *Ohio State Auditor, supra.*

In *Mobil,* this Court held (445 U.S. at 442, 435) that Mobil "failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates" because it "offered no evidence" to rebut the conclusion that the dividend-paying subsidiaries and affiliates contributed to its "worldwide petroleum enterprise." Here, appellant has met its burden under *Mobil* by showing that the "business activities of the dividend payor[s] have nothing to do with the activities of . . . [appellant] in the taxing State. . . ." (445 U.S. at 442) Appellant's New Mexico income can be fairly and adequately determined by apportioning the income from appellant's own domestic Unitary Business without taking into account the dividends from the foreign subsidiaries.[12]

II. NEW MEXICO'S INCLUSION OF THE SECTION 78 GROSS-UP AMOUNT IN APPELLANT'S APPORTIONABLE BUSINESS INCOME ALSO CONTRAVENES THE DUE PROCESS CLAUSE.

On its federal income tax return for fiscal 1977, appellant elected under section 901(a) of the Code (App. B, *infra*) to claim credits rather than deductions for foreign tax payments. Under section 902(a) of the Code (App. B, *infra*), a United States corporation owning at least 10% of the stock of a foreign corporation from which it receives dividends is deemed, for purposes of the foreign tax credit provisions of the Code, to have paid a portion of the foreign taxes actually paid by the foreign corporation. Such foreign taxes paid by the foreign corporation give rise to a "deemed paid" or "indirect" foreign tax credit. Under

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[12] This Court's treatment of the dividends from appellant's English subsidiary also should govern the treatment of appellant's foreign exchange gain from hedging those dividends. The dividends

section 78 of the Code, the United States corporation must treat the amount of the deemed paid credit as additional "gross-up" income for federal tax computation purposes.[13] However, for the reasons set forth below, there is no constitutional basis for including this gross-up amount in a resident corporation's apportionable income for state tax purposes, as New Mexico has done in this case.

The purpose of the foreign tax credit is to eliminate international double taxation by ensuring that a United States taxpayer's combined federal and foreign tax liability with respect to foreign-source income will never exceed the amount of that income multiplied by the federal or foreign tax rate, whichever is higher. Thus, in theory, the taxpayer's combined federal and foreign tax liability should always be at least equal to the amount of foreign-source income multiplied by the federal tax rate. However, prior to 1962, United States corporate taxpayers receiving dividends from foreign subsidiaries and claiming a deemed paid foreign tax credit were able, in some instances, to compute their federal tax in a way that produced a combined federal and foreign tax liability which was *less* than the amount of foreign earnings multiplied by the federal tax rate. See E. Owens and G. Ball, *The Indirect Credit* (1975), pp. 3, 57-65.

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were declared in British pounds. The hedging transactions were entered into in order to protect the dollar value of the dividends when declared, not as an independent, speculative investment. Thus, the presence of a foreign exchange gain or loss was inevitably tied to the dollar value of the dividends when received. If the dividends were worth more in dollars when received than they were when declared, appellant's hedging transaction would result in a foreign exchange loss, and *vice versa*. (See J.A. 52a-54a) This being the case, it follows that the foreign exchange gain involved here should be excluded from apportionable business income for precisely the same reasons that appellant's English dividend income should be excluded.

[13] See n. 4, p. 6, *supra*, for an example showing the calculation of the deemed paid credit and gross-up.

In order to prevent this result in the future, Congress in 1962 revised section 902(a) of the Code and enacted section 78. The Committee Reports accompanying that legislation explicitly state that the objective of these changes was to increase the United States parent corporation's effective overall tax rate on the income derived from its foreign subsidiary in those instances in which the parent corporation claimed deemed paid foreign tax credits. Thus, as part of the overall deemed paid foreign tax credit calculation, the parent corporation was required by section 78 to include the amount of the deemed paid taxes in federal taxable income as a "grossed-up" dividend. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 50-53 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 66-71 (1962); H.R. Rep. No. 2508, 87th Cong., 2d Sess. 27 (1962).

Because the federal tax rate for fiscal 1977 was 48% (see J.A. 63a, line 8), every $100 of deemed paid credit claimed by appellant on its federal tax return for that year produced a net reduction in federal tax of $52, computed as follows:

Deemed paid credit for foreign taxes	$100
Less: tax on $100 of gross-up at 48%	48
Net tax credit	$ 52

Although the net federal tax benefit, taking into account both parts of the calculation, was only $52 for every $100 of deemed paid credit, New Mexico claims that it is entitled to include the full $100 of gross-up in appellant's apportionable business income. There is no constitutional justification for such a result.

First, and most fundamentally, the section 78 gross-up is not income in any traditional sense of the word. It was not received by appellant for its separate "use, benefit, and disposal." *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1920). Nor was the gross-up an "accession . . . to wealth, clearly realized, and over which [appellant had] complete

dominion." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). As the New Mexico Supreme Court recognized, gross-up is a "fictional amount representing dividends 'deemed to have been received.'"[14] (J.S.App.A 3a)

Section 78 of the Code provides that the gross-up amount shall be "treated" as a dividend in those instances in which the recipient corporation claims a foreign tax credit. Obviously, if the gross-up truly constituted an item of income under the comprehensive definition of "gross income" in section 61 of the Code, as expansively interpreted by this Court in cases like *Commissioner* v. *Glenshaw Glass Co., supra,* it would have been unnecessary to enact section 78 in order to achieve income "treatment." As explained above, section 78 is nothing more than one part of a computational formula which is used to produce the correct amount of residual federal tax on foreign-source dividends received by a United States corporation which claims foreign tax credits; section 78 gross-up does not, separate and apart from the foreign tax credit mechanism which creates it, truly reflect income in any meaningful way. Thus, if the taxpayer decides to deduct rather than credit foreign taxes for federal tax purposes, the gross-up amount never comes into existence and *nothing* is added to the taxpayer's regular taxable income.

In view of the foregoing, the New Mexico Supreme Court was clearly correct when it recognized that the section 78 gross-up (J.S.App.A 5a) "does not fit the ordinary definition of 'income.'" Nonetheless, relying upon (1) the "power [of a State] to gauge its income tax by reference

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[14] The New Mexico Supreme Court also referred to gross-up as the "fictitious gross-up." (J.S.App.A 5a) Similarly, in *Dow Chemical Co.* v. *Commissioner of Rev.*, 378 Mass. 254, 391 N.E.2d 253 (1979), the Massachusetts Supreme Judicial Court stated (391 N.E.2d at 265):

> The gross-up foreign tax credit symbiosis is a means of calculating a suitable Federal tax credit for the United States parent and in truth it is a strain to deal with any part of it as 'income' for state purposes.

to the income on which the taxpayer is required to pay a tax to the United States," and (2) the asserted economic benefit that appellant obtained by reducing its federal tax liability through "the gross-up procedure" (J.S.App.A 5a-6a), the New Mexico Supreme Court upheld the inclusion of the gross-up in appellant's apportionable business income.

Appellant recognizes that a nondomiciliary State is entitled, as a general rule, to use a resident corporation's federal taxable income in determining the corporation's apportionable business income.[15] But, as the New Mexico statute here in issue specifically provides, federal taxable income must be "adjusted to exclude . . . amounts that the state is prohibited from taxing because of the laws or constitution of . . . the United States." (J.S.App.D 45a) Section 78 gross-up is such an amount. The inclusion of this admittedly "fictional amount" (J.S.App.A 3a) in apportionable business income at the state level, when the other part of the federal mechanism (*i.e.*, the foreign tax credit) is disregarded by the State, is manifestly unfair. It contravenes the Due Process Clause by apportioning to the nondomiciliary State an amount which has no "nexus" with the State or any "rational relationship" to "intrastate values." *Mobil*, 445 U.S. at 437. See also *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390

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[15] Appellant also recognizes that the taxing State's use of federal taxable income may change the year in which the income would ordinarily be reported, because in some instances the Internal Revenue Code has special rules for certain types of income. See, *e.g.*, *Dow Chemical Co.* v. *Commissioner of Rev.*, *supra* (State followed federal treatment of subpart F income), *Champion International Corp.* v. *Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct. App. 1975) (State followed federal treatment of income from cutting timber), and *Garlin* v. *Murphy*, 51 Misc.2d 477, 273 N.Y.S.2d 374 (1966), *aff'd*, 34 N.Y.2d 921, 359 N.Y.S.2d 552 (1974) (State followed federal treatment of a shareholder of a subchapter S corporation).

U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

Nor can appellant's federal tax benefit from its foreign tax credit election afford New Mexico any basis for taxing the section 78 gross-up. First, appellant's federal tax liability is irrelevant to the computation of New Mexico's apportionable business income which is determined without any adjustment or modification whatsoever for federal taxes. Certainly, New Mexico has not suggested that appellant could *decrease* its apportionable business income by the amount of its federal taxes. That being the case, it is anomalous for the State to suggest that apportionable business income should *increase* because of a savings in federal taxes.

Essentially the same suggestion was rejected by this Court in *Hort* v. *Commissioner*, 313 U.S. 28 (1941). In *Hort*, the taxpayer-lessor sought a deduction for lost rent as a consequence of a lease cancellation. This Court held that, for federal tax purposes, the taxpayer's lost revenues would be adequately accounted for by the fact that they would never be included in gross income; the taxpayer could not obtain a double benefit by taking a deduction against other income for the lost revenues that he had not included in income in the first place. Similarly, in this case, New Mexico cannot require appellant to include a federal tax savings in income when its federal tax liability was never deducted. Such a result is constitutionally prohibited by the Due Process Clause because it is "inherently arbitrary." *Underwood Typewriter Co.* v. *Chamberlain, supra*, 254 U.S. at 121.

As discussed above, the benefit of a taxpayer's foreign tax credit election was *reduced* in 1962 by the addition of section 78 of the Code. Yet, for years prior to 1962, New Mexico never sought to adjust a taxpayer's apportionable business income because of the taxpayer's federal foreign tax credit election. Now, as a consequence of section 78 (which has the effect of *reducing* the benefit of the foreign tax credit election), New Mexico takes the illogical position

that appellant's apportionable business income was somehow *increased.*[16]

In reaching its decision, the New Mexico Supreme Court relied on the Vermont decision in *F. W. Woolworth Co.* v. *Commissioner of Taxes,* 130 Vt. 544, 298 A.2d 839 (1972). That decision has since been overruled.[17]

Finally, even if all of the foregoing considerations were set aside and the gross-up could properly be viewed as income for state tax purposes, it would not follow that it constituted apportionable business income. We have previously shown that the dividends actually paid by the subsidiaries to appellant are not properly apportionable. *A*

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[16] In its Motion to Dismiss, appellee asserts (p. 11) that—

> The record shows that Woolworth was relieved of $25,502,782 of federal taxes which otherwise would have been due and payable by Woolworth, by virtue of being allowed to claim, as its own, foreign taxes which were actually paid by another person. In short, Woolworth pocketed $25,502,782 which it otherwise would not have had.

It is ironic, to say the least, that appellee fails to take into account appellant's federal tax payment on the very item of gross-up which appellee is seeking to treat as income here. As shown by the example on p. 27, *supra,* the net federal tax reduction which resulted from appellant's foreign tax credit election was only 52% of the $25,502,782 deemed paid credit.

[17] See *In re Appeal of Norris Knosher,* 139 Vt. 285, 428 A.2d 1104 (1981). Nor, insofar as the constitutional issue presented here is concerned, is there any other support for the result below. In *Dow Chemical Co.* v. *Commissioner of Rev., supra,* for example, Dow's taxable income was not increased by the gross-up since the gross-up was deducted under the Massachusetts statute. Thus, as the Massachusetts Supreme Judicial Court explicitly recognized (391 N.E.2d at 256-257), the constitutional issues were not reached. Similarly, in *Caterpillar Tractor Co.* v. *Lenckos,* 84 Ill.2d 102, 417 N.E.2d 1343 (1981), *prob. juris. noted sub nom., Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al.,* —— U.S. ——, No. 81-349, no constitutional issue was raised with respect to gross-up.

fortiori, the foreign tax payments which are "treated" as a grossed-up dividend for federal tax computation purposes are not apportionable. To repeat, the gross-up amount had *no* connection of any kind with any New Mexico activities.

III. ALTERNATIVELY, EVEN IF SOME PORTION OF THE DIVIDENDS, EXCHANGE GAIN, AND GROSS-UP MAY CONSTITUTIONALLY BE INCLUDED IN APPELLANT'S APPORTIONABLE BUSINESS INCOME, BOTH THE DUE PROCESS CLAUSE AND THE FOREIGN COMMERCE CLAUSE WILL BE VIOLATED UNLESS A CORRELATIVE ADJUSTMENT IS MADE TO NEW MEXICO'S APPORTIONMENT FACTORS.

A. The Due Process Clause.

The only Due Process Clause issue considered in *Mobil* was whether Mobil's dividend income from subsidiaries and affiliates could be included in Mobil's apportionable income. Because Mobil did not present the question, the Court expressly refrained from deciding whether the inclusion of such dividends in apportionable income would necessitate some correlative adjustment to Vermont's apportionment factors. See 445 U.S. at 434, 441, n. 15, and 449.

We have previously contended that, under the Due Process Clause, the dividends, exchange gain, and gross-up may not be included in appellant's apportionable business income. If, however, the Court holds that any of those items may be included in appellant's apportionable income, correlative adjustments to New Mexico's apportionment factors will be required to satisfy the requirements of the Due Process Clause. Unless the apportionment factors are adjusted, the method used by New Mexico will be "inherently arbitrary." See *Underwood Typewriter Co.* v. *Chamberlain, supra*, 254 U.S. at 121; *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra*, 266 U.S. at 282-283.

Although the Court did not reach the issue in *Mobil*, Mr. Justice Stevens stated in his dissent (445 U.S. at 461):

> Unless the sales, payroll and property values connected with the production of income by the [dividend] payor

> corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will *inevitably* cause Mobil's Vermont income to be overstated. [Footnote deleted; emphasis supplied.]

The reason for Mr. Justice Stevens' conclusion is clear. New Mexico, as a nondomiciliary State, can tax appellant only on that portion of its income which is attributable to appellant's activities in New Mexico. In determining that amount, it should make no difference whether appellant's Unitary Business (whose income is being apportioned for this purpose) is conducted through divisions or separately incorporated subsidiaries. As this Court stated in *Mobil* (445 U.S. at 440-441):

> Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). *Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.* [Footnote deleted; emphasis supplied.]

Thus, if the total amount of apportionable income in the parent-subsidiary case remains the same as it is where the parent operates through divisions, it follows that the share or percentage of that income properly apportionable to the taxing State also ought to remain the same. After all, the value of the activities carried on in the taxing State is not affected by the taxpayer's corporate structure any more than is the amount of the taxpayer's apportionable income.

However, the results of operating a unitary business through a subsidiary will *not* be the same as the results of operating through a division unless the apportionment formula is appropriately adjusted when dividends paid by the

subsidiary are included in the taxpayer's apportionable income. This can be demonstrated by assuming that the taxpayer conducts a unitary business through two divisions (Division A, which operates both inside and outside New Mexico, and Division B, which operates entirely outside New Mexico). Assume the following figures:

	Division A		Division B	
	All Locations	New Mexico Situs	All Locations	New Mexico Situs
Property	$200,000	$20,000	$100,000	-0-
Payroll	300,000	30,000	150,000	-0-
Sales	400,000	40,000	200,000	-0-
Business Income	50,000		10,000	

On these facts, the income apportioned to New Mexico will be $4,000, computed as follows:

Total Business Income = $50,000 + $10,000 = $60,000

New Mexico Factors:

$$\left[\frac{\text{Property}}{\frac{20{,}000}{300{,}000}} + \frac{\text{Payroll}}{\frac{30{,}000}{450{,}000}} + \frac{\text{Sales}}{\frac{40{,}000}{600{,}000}}\right] \div 3 = \frac{1}{15}$$

$$\text{New Mexico Taxable Income} = \$60{,}000 \times \frac{1}{15} = \$4{,}000$$

However, if the business of Division B is operated through a wholly owned subsidiary corporation, and all income of the subsidiary is distributed as a dividend to the parent and included in apportionable business income, the results will be markedly different if there is no adjustment in the parent's apportionment factors. Under these circumstances, the income apportioned to New Mexico will be increased by 50% to $6,000, computed as follows:

Parent's Business Income = $50,000 + $10,000 = $60,000

Parent's New Mexico Factors:

$$\left[\frac{\text{Property } 20{,}000}{200{,}000} + \frac{\text{Payroll } 30{,}000}{300{,}000} + \frac{\text{Sales } 40{,}000}{400{,}000} \right] \div 3 = \frac{1}{10}$$

$$\text{New Mexico Taxable Income} = \$60{,}000 \times \frac{1}{10} = \$6{,}000$$

The New Mexico Supreme Court held that inclusion of $66,979,494 of dividends, exchange gain, and gross-up in appellant's apportionable business income did not require any adjustment to the apportionment factors other than the Revenue Department's inclusion of the disputed items in the denominator of appellant's sales fraction. In rejecting appellant's claim that this adjustment to the sales fraction was insufficient, the New Mexico Supreme Court asserted that appellant had:

> . . . offered no evidence upon which further adjustments could be predicated. The Department found that Woolworth failed to present 'a reasonable and specific proposal' for further adjustments to Woolworth's payroll, sales and property factors and denied further modification to the formula. [J.S.App.A 20a-21a]

In fact, appellant specifically proposed to the Revenue Department that appellant's property, payroll, and sales factors should be adjusted to reflect the property, payroll, and sales of the foreign subsidiaries.[18] The Revenue De-

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[18] Appellant also showed that the inclusion of the gross-up would, by itself, increase apportionable business income from $18,274,068, as initially reported, to $43,776,850. (J.A. 57a, line 22; J.A. 61a, Sch. C, line 7) In comparable circumstances, the Vermont Supreme Court held in *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839, 835 (1972), that Woolworth's evidentiary burden had been satisfied because the "obvious effect" of including gross-up in apportionable income without adjusting the apportionment factors was to overstate the income taxable in Vermont. The New Mexico Supreme Court ignored this portion of the Vermont decision, but relied heavily on another portion of that

partment rejected this proposal on the merits (not for failure of proof), stating (J.S.App.A 37a):

> 21. Taxpayer argues that the Department must use the three factors of the foreign subsidiaries but it fails to suggest that the Department might then also take into account the net income of the foreign subsidiaries. In fact, however, the Department is not attempting to impose a tax on the net income of the foreign subsidiaries; the New Mexico tax is on the business income of the taxpayer and the taxpayer fails to show how the foreign subsidiaries' factors relate to this taxpayer's business income. [Footnote deleted.]
>
> 22. In its brief, the taxpayer 'petitions' for a modification of the statutory three factor formula. Assuming *arguendo* that this petition is timely, the taxpayer has not presented a reasonable and specific proposal which would meet the requirements of § 72-15A-34.

It is now clear, however, from this Court's opinion in *Mobil*, that appellant's proposal should have been accepted. In a case like this, the inclusion of dividends in apportionable business income depends on the underlying activities of the dividend-paying corporations—activities clearly carried on outside New Mexico—and not on appellant's own activities. Thus, if the dividends and the related exchange gain and gross-up are to be included in the apportionable income base (as part of the procedure for determining what may constitutionally be taxed in New Mexico), the apportionment factors must be correlatively reduced to reflect the property, payroll, and sales of the subsidiaries whose businesses generated that income. Only in that way will the result be the same as it would have been if the businesses conducted by those subsidiaries had been conducted directly in divisions of appellant. As the above example demonstrates, failure to reduce the apportionment fractions results in a *gross* overstatement of the portion of the unitary business income which is properly attributable to the taxing State and *penalizes* the taxpayer for operating through a subsidiary rather than a division.

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decision which has since been overruled. (See J.S.App.A 5a-6a and n. 17, p. 31, *supra*)

Indeed, as recently conceded by the Executive Director of the Multistate Tax Commission (the "MTC"), failure to adjust the apportionment factors in a case like the present one "produces a still higher tax result for the State" than combined reporting does.[19] This Court recently noted probable jurisdiction in a case challenging the constitutionality of combined reporting as applied to foreign subsidiaries and affiliates.[20] While we agree with the position taken by the appellant in that case, it is not necessary to reach the issues raised there to sustain appellant's position here. The MTC's admission that the decision below produces a "still higher tax result for the State" than does combined reporting is a direct acknowledgment that inclusion of dividends in the recipient's apportionable income without an adjustment in the apportionment factors results in a conceptually indefensible overstatement of the income attributable to the taxing State. As demonstrated above, the State is certainly attempting to collect a "higher tax" from appellant than it could ever hope to collect if appellant's subsidiaries were unincorporated divisions.[21] Penal-

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[19] See Corrigan, *Mobil-izing Interstate Taxation*, Tax Notes, Vol. XIII, No. 15, Oct. 12, 1981, p. 808 (comparing Cases B and E to Case C, which is comparable to the present case).

[20] *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., supra.* See also *Container Corporation of America* v. *Franchise Tax Board*, 117 Cal.App.3d 988, 173 Cal. Rptr. 121 (1981), appeal docketed, No. 81-523.

[21] In this case, the disputed additions to appellant's apportionable business income for fiscal 1977 totaled $66,979,494 (consisting of $65,383,943 of dividends and gross-up, and $1,595,551 of exchange gain). (J.A. 69a) However, *none* of the property, payroll, or sales of the dividend-paying subsidiaries were taken into account by the Revenue Department. The only token gesture made by the Department was to increase the denominator of the sales fraction by the amount added to apportionable income. As a result, the apportionment factor was reduced by .004738 of 1%. (See n.5, p.7, *supra.*) This *de minimis* adjustment was plainly inadequate to

izing appellant in this fashion is patently arbitrary and an unconstitutional violation of due process. *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission, supra; Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra; Underwood Typewriter Co.* v. *Chamberlain, supra; People ex rel. Alpha Portland Cement Co.* v. *Knapp,* 230 N.Y. 48, 129 N.E. 202 (1920). Appellee has ignored this Court's holding in *Mobil* (445 U.S. at 441) that transforming divisional profits of a unitary business into dividends "works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives."

The issue is not, as the Revenue Department would have it, whether dividends *per se* are the income of the recipient or are paid out of the income of the payor. The real issue is whether the apportionment formula fairly employs, on a consistently applied basis, factors which reflect " 'the relative contribution of the activities in the various states to the production of the total unitary income.' " *Butler Bros.* v. *McColgan, supra,* 315 U.S. at 509. Under formulary apportionment, the total income of the unitary business must be ratably divided (on the basis of the apportionment factors employed) between the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return" as is earned by the entire business collectively. Thus, where the traditional three-factor apportionment formula is properly employed, the taxing State should receive the same amount of income for every dollar of property, payroll, and sales in the State as the entire unitary business earns for every dollar of total property, payroll, and sales in all

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reflect the subsidiaries' underlying property, payroll, and sales which (1) produced the additional income, and (2) would have been taken into account had the businesses been run as unitary divisions of appellant rather than being run by separate subsidiaries.

locations. This concept *cannot possibly work*, however, if a State which uses the three-factor formula overloads its own "rate of return," as New Mexico has done here, by giving full weight to property, payroll, and sales in the State, but only token weight to sales outside the State, and no weight *at all* to property and payroll outside the State. By ignoring out-of-state property and activities, New Mexico has unfairly increased the weight given to property and activities within the State. By so doing, it seeks to increase its "rate of return" (*i.e.*, the income it earns for every dollar of local property, payroll, and sales) to a rate *higher* than the average rate applicable to the unitary business as a whole. This is so alien to the whole concept of "unitary" apportionment that it is a *per se* violation of the Due Process Clause.

This view of the conceptual relationship between apportionable business income and the apportionment factors is hardly new or novel. In addition to Mr. Justice Stevens' recognition of this relationship in his dissent in *Mobil*, see also *People ex rel. Alpha Portland Cement Co.* v. *Knapp*, *supra*, and *Household Finance Corp.* v. *State Tax Commission*, 212 Md. 80, 128 A.2d 640, 649 (1957). Cf. *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972). In the *Alpha Portland Cement* case, as here, investment income was included in apportionable income without adjusting the apportionment factor to reflect the out-of-state assets which generated the income. The court, in an opinion by Judge Cardozo, invalidated the statutory scheme, stating (129 N.E. at 204, 206):

> The interest enters into the income on which the tax has been computed; the principal has been excluded in the allocation of the assets.
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> • • •
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> Dividends from other shares, those of the Anvil Stone Company, are included in the income; the shares themselves do not enter into the terms of the proportion.
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> • • •

> [T]he statute prescribes a rule of allocation which, as applied to foreign corporations holding bonds and shares in other states, involves an artificial and arbitrary augmentation of the value of the local privilege. It measures the value of the franchise, here and elsewhere, by income from all sources, and excludes some of the same sources when the value is apportioned. *To take from assets elsewhere is equivalent to adding to assets here.*
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> * * *
>
> [A] method of apportionment which purposely ignores realities, which compels an assessor to look to some of the assets only, and close his eyes to all the others, is arbitrary and unreasonable in its increase of the local burden. [Emphasis supplied.]

Similarly, New Mexico should not be permitted to add to the income-producing value of the property, payroll, and sales in New Mexico by ignoring a substantial portion of the income-producing property, payroll, and sales outside the State. If some portion of the dividends, gross-up, or exchange gain in issue here is to be included in appellant's apportionable business income, due process requires that the apportionment factors be modified in a way which will meaningfully and fairly reflect the foreign property, payroll, and sales which generated that income.

With respect to dividends, we believe, as proposed below, that this can ordinarily best be done by increasing the denominators of the property, payroll, and sales fractions by an appropriate percentage of the property, payroll, and sales of the corporations paying the dividends. The appropriate percentage, in each case, could be determined by comparing the dividends received by appellant from a particular corporation with that corporation's earnings for that year. For example, if appellant owned 50% of a corporation's stock and the corporation paid out 30% of its earnings for the year as dividends, 15% (*i.e.*, 30% of 50%) of the corporation's property, payroll, and sales

for that year would be included in the denominators of appellant's apportionment fractions for that year.[22]

Appellee objects (Motion to Dismiss, p. 15) to the sufficiency of the evidence in this case, asserting that it fails to satisfy the "clear and cogent" standard of *Butler Bros.* v. *McColgan, supra,* 315 U.S. at 507, which applies when a taxpayer attempts to show that the taxing State's apportionment formula results in the taxation of "extra-territorial values." However, the dramatic, nearly five-fold increase in appellant's New Mexico taxable income from $84,662 to $401,518 (see p. 7, *supra*) more than satisfies any evidentiary burden. Moreover, as this Court pointed out in *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121, an apportionment formula can be invalidated by showing that it is "inherently arbitrary." In view of the demonstrated conceptual relationship between the apportionment base and the apportionment factors, New Mexico's failure to adjust the apportionment factors will "inevitably" produce an arbitrary result if the dividends or other comparable income items are included in the apportionable income base. See *Mobil,* 445 U.S. at 461 (dissenting opinion).

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[22] The same approach was taken by the Vermont Supreme Court with respect to gross-up. See *F. W. Woolworth Co.* v. *Commissioner of Taxes,* 133 Vt. 93, 328 A.2d 402 (1974). It would be equally appropriate to use this approach if appellant's exchange gain were included in apportionable income. Since the amount of exchange gain or loss depended entirely on the value of the dividend appellant received from its English subsidiary (J.A. 52a-54a), the gain could logically be treated as additional dividend income. In any event, if it becomes necessary to modify the apportionment factors in this case, we suggest that this be done, in the first instance, by the Revenue Department on remand, in the light of the specific facts of the case. Of course, appellant reserves the right to challenge the constitutionality of any modified apportionment formula adopted by the Revenue Department if that formula, as applied to appellant, results in a denial of due process as defined by this Court's decisions.

B. The Foreign Commerce Clause.

Mobil also involved the application of the Commerce Clause, but the decision there is not dispositive of the Foreign Commerce Clause issue presented here. In *Mobil*, the taxpayer argued that Vermont's tax imposed a burden on interstate and foreign commerce by subjecting Mobil's dividend income to a substantial risk of multiple state taxation. Mobil premised that multiple taxation argument on the assumption that all of its dividend income was fully taxable in the State of commercial domicile (New York, in its case) and, therefore, any apportionment to Vermont unavoidably subjected Mobil to the risk of multiple state taxation.

This Court rejected Mobil's argument, both with respect to an alleged burden on interstate commerce and with respect to foreign commerce. With respect to Mobil's foreign commerce argument, this Court stated (445 U.S. at 446-447):

> . . . Mobil suggests that dividends from foreign sources must be allocated to the State of commercial domicile, even if dividends from subsidiaries and affiliates operating domestically are not. By accepting the power of the State of commercial domicile to tax foreign-source dividend income, appellant eschews the broad proposition that foreign-source dividends are immune from state taxation. It presses the narrower contention that, because of the risk of multiple taxation abroad, allocation of foreign-source income to a single situs is required at home.
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> * * *
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> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. Thus, the only inquiry of constitutional dimension is the familiar question whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation. Once appellant's argument is placed in

this perspective, the presence or absence of taxation abroad diminishes in importance.

Appellant now asserts the Foreign Commerce Clause argument which Mobil refrained from making—namely, that *any* "local duplication of foreign taxes is proscribed."

As a general rule, *interstate* commerce is not exempt from state taxation provided the state tax in issue is applied to an activity having a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977); *Washington Rev. Dept.* v. *Stevedoring Assn.*, 435 U.S. 734, 750 (1978). But when a State seeks to tax *foreign* commerce, two additional questions must be considered: "[f]irst, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' " *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979) (hereinafter "*Japan Line*"). "If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." *Ibid.* New Mexico's tax contravenes both precepts.

1. *The Substantial Risk of Double Taxation:* There is worldwide recognition of the principle that the source nation (*i.e.*, the nation where income originates) has the primary right to tax the gross amount of dividends, interest, royalties, and other similar items of income paid by a resident of the source nation to a nonresident.[23] In accordance with that "custom of nations" (*Japan Line*, 441 U.S. at 447, 454), Canada, England, Germany, and Mexico all impose an income withholding tax on the full amount of dividends paid by resident companies to nonresident shareholders

[23] See the articles cited in nn. 29 and 30, *infra*.

ers.[24] Under these laws, as limited by applicable income tax conventions, appellant was subject in fiscal 1977 to withholding taxes equal to 15% of the full amount of its Canadian dividend, 15% of its German dividend, and 21% of its Mexican dividend.[25] As the Hearing Examiner of the Revenue Department found, appellant's foreign subsidiaries paid the foreign withholding taxes required to satisfy appellant's tax obligations with respect to the dividends it received. (J.S.App.A 31a-32a) Thus, allowing New Mexico to tax the same dividends "creates more than the *risk* of multiple taxation; it produces multiple taxation in fact." *Japan Line,* 441 U.S. at 452.

In *Japan Line,* the question was whether local governmental units in California could impose property taxes on

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[24] See the Canadian, German, and Mexican statutory provisions reproduced in App. A, *infra.* These laws clearly provide that the foreign withholding taxes are imposed on the nonresident recipient of the dividend payment. Although the tax is remitted to the foreign government by the foreign payor of the dividend, the payor is simply acting as a withholding agent for the recipient. Thus, it is clear that the taxpayer subject to foreign tax on the dividends from the Canadian, German, and Mexican subsidiaries was appellant—not the foreign subsidiaries. (See also J.A. 31a) Although appellant itself was not directly subject to United Kingdom tax in fiscal 1977 on the dividends it received during that year from its English subsidiary, appellant was subject to a 5% United Kingdom tax in 1980 with respect to those dividends as a result of the retroactive application of Article 10 of the Income Tax Convention between the United Kingdom and the United States, Dec. 31, 1975, —— U.S.T. ——, T.I.A.S. No. 9682. For an explanation of the United Kingdom tax structure as modified by the Convention, see Rev. Proc. 80-18, 1980-1 C.B. 623.

[25] The rates of tax specified in the statutory provisions referred to in n. 24, *supra,* were limited to the rates specified in the text by Article XI(1) of the Income Tax Convention between Canada and the United States, June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347; and Article VI(2) of the Income Tax Convention between Germany and the United States, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920.

cargo containers that were subject to tax in Japan. Because Japan taxed the full value of the containers, this Court held that *any* additional state tax, regardless of how that tax was apportioned, would inevitably produce double taxation in contravention of the Foreign Commerce Clause.

We recognize that a different situation may be presented in the case of income taxes. The theory of apportionment, as applied in an income tax context, is that the taxing State is not taxing any out-of-state income as such, but is simply using the out-of-state income, and the out-of-state property, payroll, and sales factors, as a means of more accurately calculating the portion of the total income which is fairly attributable to the activities in the taxing State. Thus, if foreign-source income items which have been taxed abroad are included in the apportionable income base, it is conceivable that multiple income taxation by the State could be avoided by a correlative decrease in the apportionment factors to reflect the foreign property, payroll, and sales associated with that income.[26] We have previously argued that such an adjustment to the apportionment factors is required by the Due Process Clause. However, if the Court holds that the Due Process Clause does not require New

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[26] Since such an adjustment to the apportionment factors would decrease the percentage of the other apportionable income that would otherwise be taxed by the nondomiciliary State, the adjustment could theoretically offset the effect of imposing a second tax on a portion of the foreign-source income.

There are, however, powerful arguments which can be made to support the conclusion that unitary apportionment of foreign-source income in this fashion is not constitutionally acceptable in practice, even if theoretically appropriate apportionment factors are used. See the Jurisdictional Statements filed in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., supra,* and *Container Corporation of America* v. *Franchise Tax Board, supra.* We need not now reach that issue in this case, since it is clear that New Mexico has made no meaningful adjustment to its regular apportionment factors, with the result that a double tax is being asserted. If this case is remanded for

Mexico to make a correlative adjustment to the apportionment factors, New Mexico would then be taxing a portion of the foreign dividends and gross-up *in addition to* its full share of the other apportionable business income. Under these circumstances, it *unavoidably* follows that the dividends and gross-up would be subject to multiple taxation—full taxation by the source nation and partial taxation by New Mexico. Such a result cannot be squared with *Japan Line.*

2. *Federal Government Policy:* The remaining consideration that must be taken into account under *Japan Line* is whether the asserted state tax may "impair federal uniformity" by preventing the Federal Government from "'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line,* 441 U.S. at 448, 451.

Since the enactment of sections 222 and 238 of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, the revenue laws of the United States have been premised on the principle that the jurisdiction where income is generated has the primary right to tax that income, with the result that United States taxpayers should be allowed to reduce their regular federal tax liability by the amount of foreign income tax paid on their foreign-source income.[27] Surrey, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 Colum. L. Rev. 815, 817 (1956); E. Owens, *The Foreign Tax Credit*

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the purpose of permitting the State to modify the apportionment factors, appellant reserves the right to challenge the constitutionality of the modified apportionment formula if, in light of the facts and this Court's decisions, the formula as applied to appellant still results in the effective imposition of a state tax on foreign-source income which has already been taxed abroad.

[27] The foreign tax credit provisions were originally adopted in the Revenue Act of 1918 in order to relieve a "very severe burden" imposed as the result of multiple taxation. H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918) (1939-1 C.B. (Pt. 2) 86, 93). See *Burnet* v. *Chicago Portrait Co.,* 285 U.S. 1, 7 (1932).

(1961), pp. 2-3, 590-591. The United States has also sought to reduce the risk of double taxation of dividends through tax treaties which assure that the recipient's country will allow a credit or offset for taxes paid to the source country.[28] The position taken by the United States in its treaties is in accordance with model international tax conventions which have recognized the primary right of the source nation to impose a tax on corporate dividends, with the nation where the shareholder resides having a concomitant responsibility to reduce its regular tax on that dividend income by an equivalent amount. See Article 10, Article 23A, and Article 23B of the Draft Double Taxation Convention on Income and Capital (1963) adopted by the Organization for Economic Co-Operation and Development (the "OECD").[29]

It is obvious, we think, that the United States can speak with "one voice" in regulating foreign commerce only if the States and political subdivisions that choose to tax income from foreign commerce are required to recognize and implement the basic policies which the Federal Government applies in taxing such income. The avoidance of double taxation of foreign-source income is such a policy. Moreover, the Federal Government's policy in this area is clearly in accord with the "custom of nations." See *Japan*

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[28] Provisions to this effect are included in 27 ratified conventions and 13 pending conventions between the United States and various foreign countries. These conventions are listed in App. C, *infra*.

[29] The United States Department of Treasury has adopted the OECD model convention as its basic negotiating position in bilateral income tax treaty negotiations. 46 Fed. Reg. 37432 (July 20, 1981). For a discussion of comparable concepts previously developed by the Fiscal Committee of the League of Nations in its model convention, see Ke Chin Wang, *International Double Taxation of Income: Relief Through International Agreement 1921-1945*, 59 Harv. L. Rev. 73, 81-97 (1945).

Line, 441 U.S. at 447, 454. Virtually every developed non-communist country in the world has an income tax structure which is designed to avoid double taxation of international income by effectively giving taxing priority to the source nation.[30]

Because this policy is firmly embedded in federal law and treaties, and clearly constitutes the custom of nations, we think it is constitutionally intolerable for the States to disregard it. Put differently, we believe that any State choosing to include foreign-source income in its apportionable tax base has a constitutional obligation to devise some mechanism which will effectively prevent the imposition of a second tax on any income that has already been taxed abroad by the source nation.[31]

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[30] This is generally done either by excluding the foreign-source income from the tax base altogether, or by taxing it and then allowing a credit for the tax imposed by the source nation. See Dr. D. Juch, "General Report on Unilateral Measures to Prevent Double Taxation," *Cahiers de Droit Fiscal International*, Vol. LXVI b, International Fiscal Association, XXXV Congress, Berlin (1981) and the more detailed national reports which follow in the same volume.

[31] The fact that bills regulating state taxation of foreign income have been introduced in Congress, but not enacted, should not prevent this Court from requiring the States to act in a manner consistent with long-standing, consistently implemented federal policy. Congressional failure to act should not be viewed as tacit approval of current state practices where, as here, it can be shown that those practices are fundamentally at odds with the Federal Government's taxing policy with respect to foreign income as evidenced by laws which Congress *has* enacted and treaties which the Senate *has* ratified. State action which imposes a clear burden on foreign commerce by subjecting foreign income to double tax is contrary to the Foreign Commerce Clause and should therefore be prohibited by this Court until and unless Congress takes affirmative action to sanction it.

In *Mobil*, this Court stated (445 U.S. at 448) that "[a]bsent some explicit directive from Congress, we cannot infer that treat-

New Mexico's taxing statute does not comport with federal policy, either in concept or in practice. New Mexico makes no effort to reflect, in any way, the foreign withholding taxes imposed on foreign-source dividends, interest, royalties, or other similar income items received by New Mexico residents. Thus, if appellant's Canadian subsidiary declares a $100 dividend to appellant, withholds the $15 of Canadian tax which appellant owes, and remits the remaining $85 to appellant, New Mexico will include the full $100 in appellant's apportionable business income. Moreover, New Mexico will tax a portion of that amount without allowing any credit or other offset for the $15 Canadian withholding tax borne by appellant on the same income, and without making any meaningful adjustment to the regular New Mexico apportionment factors.

This Court cannot prevent Canada and other foreign countries from continuing to tax appellant on 100% of the dividends it receives from those countries. See *Japan Line*, 441 U.S. at 447-448. Accordingly, inclusion of the dividends in appellant's apportionable income for state tax purposes, without offsetting relief, inevitably means that more than 100% of the income will be taxed. The resulting

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ment of foreign income at the federal level mandates identical treatment by the States." However, this statement was clearly made in the context of a discussion which was *not* dealing with "problems of duplicative taxation at the international level" but was, instead, focusing on "the wholly different sphere of multiple taxation among our States." *Ibid.* Where, however, foreign commerce is involved, this Court has made it clear that the States are not "free to impose demonstrable burdens" on such commerce simply because Congress has not "pre-empted the field by affirmative regulation." *Japan Line*, 441 U.S. at 454. This is because:

> [I]t long has been "accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests." [Citation deleted; *Ibid.*]

double taxation imposes an actual burden on foreign commerce which is significant now[32] and could become appreciably greater in the near-term future.[33] We urge this Court to eliminate that burden by applying the principles of *Japan Line* to state income as well as property taxes.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below and remand the case to the Supreme Court of New Mexico for further proceedings in conformity with this Court's opinion.

Respectfully submitted,

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[32] There are presently at least 27 States which apportion dividend income. See Appendix F to the Jurisdictional Statement filed in *Mobil*, a copy of which is reproduced in App. D, *infra*. In 1974, the latest year for which federal tax return statistics are available, United States corporations claiming a foreign tax credit received foreign-source dividends of over $6.1 billion. 1974 Statistics of Income, International Income and Taxes, Foreign Tax Credit (GPO, Washington, D.C. 1980), p. 9, col. 2.

[33] The earnings which United States companies have repatriated from direct foreign investments have increased five-fold in the last decade "to an estimated $41 billion for 1981." See Janssen, *Tracking a Trend*, Wall St. J., Mar. 11, 1981, p. 56. There is every reason to expect this trend to continue.

APPENDIX A

The Income Tax Act [of Canada], S.C. 1970-71-72, c. 63, as amended and in effect on January 1, 1977:

SEC. 212(2). TAX ON DIVIDENDS.

Every non-resident person shall pay an income tax of 25% on every amount that a corporation resident in Canada pays or credits, or is deemed by Part I to pay or credit, to him as, on account or in lieu of payment of, or in satisfaction of a taxable dividend (other than a capital gains dividend within the meaning assigned by subsection 130.1(4), 131(1) or 133(7.1)) or a capital dividend.

SEC. 215(1). DEDUCTION AND PAYMENT OF TAX.

When a person pays or credits or is deemed to have paid or credited an amount on which an income tax is payable under this Part, he shall, notwithstanding any agreement or any law to the contrary, deduct or withhold therefrom the amount of the tax and forthwith remit that amount to the Receiver General on behalf of the nonresident person on account of the tax and shall submit therewith a statement in prescribed form.

Einkommensteuergesetz (EStG) [Income Tax Law of West Germany], *Tax Laws of the World, West Germany* (Foreign Tax Law Association, Inc. 1980):

ARTICLE 20.

(1) To income from capital assets belong:

1. Profit shares (dividends), interest, gains and similar amounts from stocks, mining shares, participation certificates with the rights of profit sharing and of participating in liquidation proceeds of a corporation, shares in limited liability companies, in industrial and commercial coopera-

tives, colonial companies and mining associations which have the status of juristic persons.

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ARTICLE 43. Capital Receipts Subject to Tax Deduction.

(1) In the case of the following capital receipts within the country, the income tax is collected by means of deduction on the capital receipt (Capital Receipts Tax):

1. Profit shares (dividends), interest, gains and similar receipts from stocks, mining shares, participation shares, shares in limited liability companies, in cooperative associations and agricultural associations, and colonial companies, from shares in the Reichs bank, and in mining associations which have the character of a juristic person. In this class belong profit shares and other receipts in the sense of Article 3b, and not interest from commercial loans, to the extent that they fall under numeral 3 or 5;

ARTICLE 44.

(1) The creditor is the tax debtor in the case of tax deduction on capital receipts (Capital Receipts Tax). The debtor of the capital receipts, however, is liable for the withholding and retention of the capital receipts tax....

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ARTICLE 49. Income Subject to Limited Tax Liability.

(1) Domestic income in the sense of limited tax liability is the following:

• • • • •

5. Receipts from capital assets in the sense of Article 20, paragraph 1, numerals 1, 2, 4, 6 and 7, if the debtor has a residence, place of business, or

domicile within national territory, and receipts in the sense of Article 20, paragraph 1, numerals 5 and 8, if the capital assets are protected directly or indirectly by domestic national law, by domestic legal right, which lies under the provisions of the civil law on real property.

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Korperschaftsteuergesetz (KStG) [Corporation Tax Law of West Germany] H. Ault and A. Radler, *The German Corporation Tax Reform Law* (1977).

ARTICLE 50. Special Provisions for the Withholding of Tax on Capital Yields.

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(2) Corporation tax on those categories of income which are subject to withholding tax is satisfied by such withholding tax.

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2. if the recipient of the income is subject to limited tax liability and the income is not attributable to a domestic commercial or agricultural establishment . . .

Income Tax Law of Mexico*

CHAPTER II

TAX ON INCOME FROM CAPITAL INVESTMENTS AND OTHER INCOME.*

ARTICLE 60. [Income subject to tax.] The tax referred to in this chapter is imposed on any receipts in cash or in kind derived from the following:

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* These statutes were excerpted from the Commerce Clearing House Spanish-English Edition of the Mexican Income and Commercial Receipts Tax Law effective January 1, 1977.

V. Income from profits distributed by all kinds of legal entities or enterprises who are not individuals, which are established in Mexico, and from profits which should be distributed by such legal entities or enterprises when they discontinue and liquidate their business or businesses and by branches or agencies of foreign entities established in Mexico.

ARTICLE 61. [Persons subject to tax.] The tax on income from capital investments and other income is imposed on the persons receiving the income described in the preceding article notwithstanding any agreement or pact to the contrary.

* * * * *

ARTICLE 73. [Income from company distributions.] The tax to which paragraph V of Article 60 refers is imposed:

I. In the case of all Mexican corporations and entities:

a). On the distributed profits;

* * * * *

ARTICLE 74. [Rates.] The tax to which paragraphs I, III and IV of the preceding article refer is the amount resulting from applying to the taxable income the 15% rate when the tax rules for nominative securities apply and the 21% rate when the rules for bearer securities apply. The tax shall not be imposed when the same person receiving the profit or dividend reinvests such amount for the subscription and payment of new capital in the same company within thirty days following the distribution; but if the company is liquidated or its capital is reduced through reimbursement to the partners, the tax shall be imposed.

* * * * *

The payor of the income tax by this article must withhold the tax and furnish the information required by the Ministry of Finance and Public Credit using the proper official forms. The withholding relating to securities which have been subject to tax under the rules that apply to bearer securities shall be considered the final payment.

APPENDIX B

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 78. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a)(1) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

(a) ALLOWANCE OF CREDIT. If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating to minimum tax for tax preferences), against the tax imposed for the taxable year under section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), against the tax imposed

by section 402(e) (relating to tax on lump sum distributions), against the tax imposed for the taxable year by section 408(f) (relating to additional tax on income from certain retirement accounts), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1351 (relating to recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION.—For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

APPENDIX C

U.S. Income Tax Conventions Providing for Relief from Double Taxation by Allowance of a Credit to a Resident Taxpayer for Taxes Paid to the Source Nation:

A. Ratified Income Tax Conventions between the United States and:

Australia (Art. XV), May 14, 1953, 4 U.S.T. 2274, T.I.A.S. No. 2880; Austria (Art. XV), Oct. 25, 1956, 8 U.S.T. 1699, T.I.A.S. No. 3923; Belgium (Art. 23), July 9, 1970, 23 U.S.T. 2687, T.I.A.S. No. 7463; Canada (Art. XV), June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347; Denmark (Art. XV), May 6, 1948, 62 Stat. 1730, T.I.A.S. No. 1854; Finland (Art. 5), Mar. 6, 1970, 22 U.S.T. 40, T.I.A.S. No. 7042; France (Art. 23), July 28, 1967, 19 U.S.T. 5280, T.I.A.S. No. 6518, as amended, Nov. 24, 1978, 30 U.S.T. 5110, T.I.A.S. No. 9500; West Germany (Art. XV), July 22, 1954, 5 U.S.T. 2768, T.I.A.S. No. 3133, as amended, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920; Greece (Art. XIV), Feb. 20, 1950, 5 U.S.T. 47, T.I.A.S. No. 2902; Hungary (Art. 20), Feb. 12, 1979, 30 U.S.T. 6357, T.I.A.S. No. 9560; Iceland (Art. 5), May 7, 1975, 26 U.S.T. 2004, T.I.A.S. No. 8151; Ireland (Art. XIII), Sept. 13, 1949, 2 U.S.T. 2303, T.I.A.S. No. 2356; Italy (Art. XV), Mar. 30, 1955, 7 U.S.T. 2999, T.I.A.S. No. 3679; Japan (Art. 5), Mar. 8, 1971, 23 U.S.T. 967, T.I.A.S. No. 7365; Korea (Art. 5), June 4, 1976, 30 U.S.T. 5253, T.I.A.S. No. 9506; Luxembourg (Art. XVI), Dec. 18, 1962, 15 U.S.T. 2355, T.I.A.S. No. 5726; Netherlands (Art. XIX), April 29, 1948, 62 Stat. 1757, T.I.A.S. No. 1855, as amended, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051; New Zealand (Art. XIII), Mar. 16, 1948, 2 U.S.T. 2378, T.I.A.S. No. 2360; Norway (Art. 23), Dec. 3, 1971, 23 U.S.T. 2832, T.I.A.S. No. 7474; Pakistan (Art. XV), July 1, 1957, 10 U.S.T. 984, T.I.A.S. No. 4232; Poland (Art. 20), Oct. 8, 1974, 28 U.S.T. 891,

T.I.A.S. No. 8486; Romania (Art. 21), Dec. 4, 1973, 27 U.S.T. 165, T.I.A.S. No. 8228; Sweden (Art. XIV), Mar. 23, 1939, 54 Stat. 1759, T.I.A.S. No. 958, as amended, Oct. 22, 1963, 15 U.S.T. 1824, T.I.A.S. No. 5656; Switzerland (Art. XV), May 24, 1951, 2 U.S.T. 1751, T.I.A.S. No. 2316; Trinidad and Tobago (Art. 4), Jan. 9, 1970, 22 U.S.T. 164, T.I.A.S. No. 7047; Union of South Africa (Art. IV), Dec. 13, 1946, 3 U.S.T. 3821, T.I.A.S. No. 2510; United Kingdom (Art. 23), Dec. 31, 1975, —— U.S.T. ——, T.I.A.S. No. 9682.

B. Pending Income Tax Conventions between the United States and:

Argentina (Art. 23), May 7, 1981; Bangladesh (Art. 22), Oct. 6, 1980; Brazil (Art. 4), Mar. 13, 1967; British Virgin Islands (Art. 22), Feb. 18, 1981; Cyprus (Art. 5), Mar. 26, 1980; India (Art. XII), Nov. 10, 1959; Israel (Art. 26), Nov. 20, 1975; Jamaica (Art. 24), May 21, 1980; Malta (Art. 24), Mar. 21, 1980; Morocco (Art. 21), Aug. 1, 1977; Philippines (Art. 23), Oct. 1, 1976; Thailand (Art. 22), Mar. 1, 1965; United Arab Republic (Art. 25), Aug. 24, 1980. The pending conventions may be found in Volumes 1 and 2 of the Commerce Clearing House Tax Treaties looseleaf service.

APPENDIX D

Appendix F to Jurisdictional Statement in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980)

Appendix F

ALLOCATION OR APPORTIONMENT OF DIVIDENDS INCLUDED IN THE TAX BASE *

State [1]	All Taxable Dividends Allocated to Commercial Domicile	Non-Business Dividends Allocated to Commercial Domicile and Business Dividends Apportioned	All Taxable Dividends Apportioned
Alabama		X	
Alaska		X	
Arizona	X		
Arkansas		X	
California	X		
Colorado		X	
Delaware			X
District of Columbia		X	
Hawaii		X	
Idaho		X	
Illinois		X	
Indiana		X	

* This table includes only jurisdictions which include foreign source dividends, in part or in whole, in the tax base. Georgia, Florida and Ohio have been omitted because foreign source dividends are not taxable (Ga. Code § 92-3102, CCH 10-512, 11-512), or they are taxable only if the payor transacts a substantial portion of its business, or has a substantial portion of its assets in the United States (Fla. Stat. § 220.13, CCH 10-310), or has physical assets located in the State (Ohio Rev. Code Ann. § 5733, CCH 10-309, 336, 378, 11-425).

[1] Ala. Code Tit. 40, § 40-18-34, CCH 10-535, 15-090; Alaska Stat. §§ 43.19.010, 43.20.065, CCH 12-417, 418; Ariz. Rev. Stat. § 43-135(g), CCH 12-405; Ark Stat. Ann. §§ 84-2055(a), 2058, 2061,

State [1]	All Taxable Dividends Allocated to Commercial Domicile	Non-Business Dividends Allocated to Commercial Domicile and Business Dividends Apportioned	All Taxable Dividends Apportioned
Kansas		X	
Louisiana	X		
Maine		X	
Maryland			X
Massachusetts			X
Minnesota	X		
Mississippi	X		
Montana		X	
Nebraska		X	

2063, CCH 11-537, 572; Cal. Rev. & Tax. Code, § 25126, CCH 12-428; Colo. Rev. Stat. § 24-60-1301, CCH 12-538; Del. Code Tit. 30, § 1903(b)(6), CCH 10-840; D.C. Code § 47-1580(a), CCH 12-405, 413; Haw. Rev. Stat. §§ 235-22, 27, 29, CCH 12-530, 540; Idaho Code § 63-3027(g), (i), CCH 12-490, 510; Ill. Rev. Stat. Ch. 20, § 301, 304, CCH 90-907, 916; Ind. Code Ann. § 6-3-2-2, CCH 12-405, 415, 448; Kan. Stat. §§ 79-3274, 3277, 3279, CCH 12-478, 490; La. Rev. Stat. Ann. § 243, CCH 12-411; Me. Rev. Stat. Tit. 36, §§ 5211(6), (8), CCH 12-460, 465; Md. Ann. Code Art. 81, § 316 (c), CCH 12-410, 420; Mass. Gen. Laws Ann. Ch. 63, § 38(a) (1), (c) CCH 10-324, 330; Minn. Stat. § 290.17, CCH 12-407; Miss. Code Ann. § 27-7-23(1)(a); Miss. Inc. Tax Reg. § 1.27-7-23(1), CCH 12-405, 407, 435; Mont. Rev. Codes Ann. § 84-1503, CCH 11-501(c), (f), (h); Neb. Rev. Stat. § 77-2735(4), 2741, 2743, CCH 12-425, 445, 455; N.H. Rev. Stat. Ann. § 77-A:3, CCH 15-350, 355; N.J. Rev. Stat. § 54:10A-6, CCH 5-805, 810; N.M. Stat. Ann. §§ 72-15A-20, 23, CCH 12-425, 455, 465; N.C. Gen. Stat. § 105-130.4(c), (f), (i), CCH 10-805, 820; N.D. Cent. Code § 57-38.1, CCH 12-454, 460, 464; Okla. Stat. Tit. 68, § 2358A, CCH 12-425; Or. Rev. Stat. § 314.625, 640, 650, CCH 12-414, 418, 422; R.I. Gen. Laws § 44-11-14, CCH 10-810; S.C. Code § 12-7-1120, CCH 12-435; Tenn. Code Ann. § 67-2709, 2712, 2714, CCH 12-419, 425, 429; Utah Code Ann. § 59-13-81, 84, 86, CCH 11-515, 530, 540; Vt. Stat. Ann. Tit. 32, § 5833(a), CCH 12-410; Wis. Stat. Ann. § 71.07 (1m) (2), CCH 12-404(a), 409. All CCH references are to the relevant paragraphs in the Commerce Clearing House, Inc. State Tax Reporter Service.

State [1]	All Taxable Dividends Allocated to Commercial Domicile	Non-Business Dividends Allocated to Commercial Domicile and Business Dividends Apportioned	All Taxable Dividends Apportioned
New Hampshire			X
New Jersey			X
New Mexico		X	
North Carolina		X	
North Dakota		X	
Oklahoma	X		
Oregon		X	
Rhode Island			X
South Carolina	X		
Tennessee		X	
Utah		X	
Vermont			X
Wisconsin			X
Total [2]	7	19	8

[2] Four States that tax foreign source dividends have been omitted from the table because their methods of allocation or apportionment do not fit into the scheme used by most States.

Connecticut: Allocates dividends from subsidiaries by reference to the ratio of the payor's business done in the State; nonsubsidiary dividends are apportioned if they constitute an integral part of the recipient's regular business operations (Conn. Gen. Stat. § 12-218, CCH 10-815, 825).

Iowa: There appears to be a conflict between the statute and the rules as to the extent to which dividends are allocated or apportioned (Iowa Code § 422.33, CCH 12-520; Iowa Rule 54.2(1), CCH 12-522).

New York: Includes in the tax base only non-subsidiary dividends (to the extent of 50%), which it allocates in the ratio of the payor's New York apportionment percentages (N.Y. Tax Law § 210, CCH 5-829—841, 9-581).

Virginia: Dividends of non-subsidiaries are allocated to the State if it is the recipient's commercial domicile; dividends paid by subsidiaries are apportioned (Va. Code § 58-151.040, CCH 12-445).

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IN THE

Supreme Court of the United States

October Term, 1981

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLEE

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QUESTIONS PRESENTED

1. Whether the due process clause prohibits the inclusion in apportionable business income of income earned from shares of stock and other intangibles when the income-producing intangibles were acquired and managed as integral parts of the taxpayer's regular unitary business.

2. Whether the inclusion of intangible income in apportionable business income requires alteration of New Mexico's apportionment formula, as a constitutional matter, when the amount apportioned to New Mexico by the unchanged formula is reasonably related to the taxpayer's activities in the state.

3. Whether New Mexico may define a taxpayer's business income by reference to its federal taxable income, without adjustment, when the federal amount includes section 78 dividends.

4. Whether the foreign commerce clause bars a state from including in the apportionable business income of a domestic taxpayer its dividend income earned from its investments in stock of a foreign corporation.

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F. W. WOOLWORTH CO., *Appellant,*

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TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

BRIEF OF APPELLEE

STATEMENT OF THE CASE

The taxpayer in this case is F. W. Woolworth, a New York corporation. It operates a single, integrated business in the United States, Puerto Rico and the Virgin Islands. (J.A. 10a)

Woolworth's activities in New Mexico are substantial. During 1976, Woolworth had $8.8 million[1] of tangible assets located in New Mexico, had a payroll of almost $2 million, and made sales of more than $13 million within the state. (J.A. 57a) Yet Woolworth contends that formulary attribution of $401,000 of income to New Mexico in fiscal 1977, and the resulting New

[1] These numbers are rounded for convenience. Precise amounts appear on Woolworth's corporate income tax return in the Joint Appendix, at 55a and 57a.

Mexico tax liability of $20,000, violates the due process and commerce clauses of the United States Constitution. Implicit in its argument is the conclusion that the Constitution allows New Mexico only $4,358 return for the opportunity New Mexico provided Woolworth to obtain $13 million in gross receipts here.

The constitutional controversy arises from the requirements of New Mexico's tax statute.[2] Despite this Court's holding in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), that dividend income received from foreign subsidiaries may be included in apportionable income, Woolworth argues that the Constitution prohibits inclusion of dividend income and foreign exchange gain in a taxpayer's apportionable business income. Additionally, Woolworth objects to New Mexico's reliance on federal taxable income as the base for the state's income tax, insofar as that method results in the inclusion of section 78 dividends (gross-up) as apportionable business income.

Under the New Mexico statute,[3] a multistate taxpayer such as Woolworth has two choices: it may determine its New Mexico taxable income by separately accounting for its New Mexico activities; or it may elect to determine the amount of its total business income attributable to New Mexico by allocating and

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[2] New Mexico's income tax statute was changed substantially by the 1981 Legislature. Those changes essentially divided the Income Tax Act into a personal and a corporate statute, and made other, substantive changes. However, none of the substantive changes affects the substance of the statutory sections discussed in this brief. For purposes of this brief, statutory cites are to the pre-1981 New Mexico Income Tax Act, unless indicated otherwise. The New Mexico statutes applicable to this case are set out in the appendix.

[3] New Mexico has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with few modifications. It has also joined in the Multistate Tax Compact, §§7-5-1 through 7-5-7 NMSA 1978.

apportioning its total business[4] income under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). Woolworth chose to report to New Mexico under UDITPA. Under UDITPA, business income is:

> income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;

Section 7-4-2(A) NMSA 1978.

UDITPA apportions income in accordance with unitary business principles. A finding that income is business income under UDITPA, is equivalent to a finding that such income is unitary business income. *See Tipperary Corp. v. New Mexico Bureau of Revenue,* 93 N.M. 22, 595 P.2d 1212, (Ct.App. 1979), *cert. denied,* 92 N.M. 675, 593 P.2d 1078 (1979).

A taxpayer's business income is normally[5] the same amount as its federal taxable income, unless the taxpayer shows that some portion of its total income is attributable to nonbusiness activities. Nonbusiness income is allocable in accordance with

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[4] If the taxpayer reporting to New Mexico is part of a multicorporate unitary business, as Caterpillar Tractor Co. was shown to be in *Chicago Bridge and Iron Co. v. Caterpillar Tractor Co., prob. juris. noted,* __U.S.__, No. 81-349, New Mexico law allows a combined report of all the corporations included in the unitary business. In a combined report, the income of all the included corporations is combined (excluding income from intercorporate transactions) to indicate the business income of the combined group, and the total income is apportioned by reference to the property payroll and sales of all the corporations whose income is included in business income. (R. 49; N.M. Income Tax Regulation 18(b)(2), at R. 130 on back)

[5] Excluded by statute from federal taxable income are certain amounts taxed under the Banking and Financial Corporations Tax Act, and amounts a state is prohibited from taxing by law or constitution. Section 7-2-2(S) and (T) NMSA 1978. (J.S.A. 45a)

UDITPA rules. Sections 7-4-5 through 7-4-9 NMSA 1978. (Appendix A, p. 3a-4a)

On its federal return, Woolworth reported total income for its fiscal year ending January 31, 1977, as $997 million. After deductions, Woolworth's federal taxable income totaled $87 million. In its New Mexico return, Woolworth subtracted $69 million from this taxable income amount as "nonbusiness income." This nonbusiness income consisted of $65.4 million of dividend income,[6] $2.4 million of interest income and $1.6 million of income from an investment it calls a foreign exchange hedging transaction. (J.A. 57a) Woolworth reported no expenses related to any of these items of income.[7] By virtue of this subtraction of alleged nonbusiness income, Woolworth calculated its total apportionable business income to be $18.3 million. Application of the apportionment formula to this amount resulted in apportionment of only $84,000 of income to New Mexico. The tax Woolworth paid on this amount was $4,358.[8]

Upon audit, the New Mexico Taxation and Revenue Department (hereinafter, New Mexico) determined that Woolworth erroneously classified the $69.3 million as nonbusiness income, and New Mexico restored that amount to the business income total.

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[6] Included in the $65.4 million of dividend income was $25.5 million of gross-up. Gross-up is part of the federal formula allowing a taxpayer to claim a credit for taxes paid by a subsidiary corporation if it increased its gross income by the amount deemed to have been paid. *See* discussion, *infra*, p. 35.

[7] Since the UDITPA allocation and apportionment provisions apply to "net" income, the expenses connected with an item of nonbusiness income must be considered as nonbusiness expenses, and allocated in accordance with the income to which it is related.

[8] Section 7-2-8 NMSA 1978 provided a corporate tax rate of five percent. This amount has since been changed to a sliding scale ranging from four to six percent, depending upon the amount of New Mexico income. Section 7-2A-5 NMSA 1978 (1981 Repl. Pamph.).

New Mexico then added into "sales everywhere"[9] the amount Woolworth received as dividends, interest and foreign exchange gain, which addition resulted in an adjusted apportionment formula and a reduction in the percentage of Woolworth's total sales attributable to New Mexico.[10] (J.A. 69a) The use of the numbers calculated by the taxpayer as the property percentage and the payroll percentage, and the reduced sales percentage calculated by New Mexico resulted in a smaller and more realistic representation of the proportion of the total business income of the taxpayer attributable to New Mexico. New Mexico applied the resulting percentage, .458335 percent – less than one-half a percent – to the amount concluded to be the taxpayer's business income, and determined that Woolworth had underpaid New Mexico by $15,845 plus interest. (J.A. 67a-68a) The taxpayer's protest[11] to the ensuing assessment brought the case to hearing before a Taxation and Revenue Department hearing examiner.

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[9] "Sales" means "gross receipts," §7-4-2(E) NMSA 1978.

[10] *Woolworth's original formula:*

$13,253,425 N.M. sales / 2,507,990,364 sales everywhere = .528448% sales in N.M.

$ 1,996,950 N.M. payroll / 482,517,853 payroll everywhere = .413860% payroll in N.M.

$ 8,750,664 N.M. property / 1,958,028,204 property everywhere = .446912% property in N.M.

$$\frac{.528448\%\ (\text{sales}) + .413860\%\ (\text{payroll}) + .446912\%\ (\text{property})}{3} = .463073\%$$ of Woolworth's business activities taking place in N.M.

New Mexico's changes to the formula:

$13,253,425 N.M. sales / 2,577,319,999 sales everywhere = .514233% sales in N.M.

$$\frac{.514233\%\ (\text{new sales}) + .413860\%\ (\text{same payroll}) + .446912\%\ (\text{same property})}{3} = .458335\%$$ of Woolworth's business activities taking place in N.M. (reduced from .463073% submitted by Woolworth).

[11] J.A. 67a.

The evidence in this case establishes that Woolworth's entire income is business income of its unitary business. Woolworth has consistently maintained that its domestic[12] operations constitute a unitary enterprise. (R. 149) Some of Woolworth's unitary income arises from its activities operating retail stores, which use the names Woolworth and Woolco. (J.A. 10a) However, the taxpayer's retail activities are by no means the only source of income admitted to be business income. Woolworth derives business income from interest on loans made by it as "part of the regular trade of [*sic*] business of Woolworth." (J.A. 9a) Specifically, in this case, interest was paid to Woolworth by its Canadian subsidiary (R. 141) which also paid some of the dividend income that Woolworth argues is *not* business income. Woolworth also admits that "in the regular course of its business" it routinely invests in commercial paper and treasury notes. (J.A. 27a) Thus, neither the nature of the dividend income, as income from intangibles, nor the fact that it is paid by Woolworth's foreign subsidiaries, distinguishes it from Woolworth's other conceded business income.

Moreover, the evidence shows that Woolworth's regular trade or business activities include extensive management of the intangible property from which the dividends in this case are derived. The taxpayer owns a majority interest, either directly or through subsidiaries, in at least 32 subsidiary corporations (R. 140, Appendix B, p. 10a). Many of these are corporations operating under the Woolworth name all over the world.[13] Of these Woolworth corporations, the English, German, Canadian and Mexican operations paid dividends to their parent in 1976.

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[12] "Domestic" is used here to indicate Woolworth's operation in the United States, Puerto Rico and the Virgin Islands.

[13] The exhibit submitted by the taxpayer showing its corporate structure indicates Woolworth corporations operating in Canada, Germany, England, Austria, Jamaica, Trinidad, Barbados, Spain, Southern Rhodesia and Mexico. (Appendix B, p. 10a)

F. W. Woolworth Co., Ltd., is an English corporation, 52.7 percent of which is owned by taxpayer. F. W. Woolworth, Gmbh, the German subsidiary, F. W. Woolworth, Ltd., the Canadian subsidiary, and F. W. Woolworth, S.A. de C.V. Mexico are wholly owned subsidiaries of the taxpayer. (J.S.A. 33a) These foreign subsidiaries conduct the same type of retail operations as does the taxpayer, under the Woolworth name. (J.A. 21a-22a) The taxpayer's overall financing and planning include and are integrated with that of its foreign subsidiaries and affiliates. (J.A. 27a-28a)

Management autonomy has been granted to each subsidiary in accordance with development of its abilities to act independently of the taxpayer. (J.A. 26a, 29a) The New York parent, in recognition that the success of a marketing operation such as a Woolworth store depends upon its ability to determine and cater to the needs of the people comprising the market, has developed a uniform "merchandising concept" applicable to all of its subsidiaries: goods sold in local stores should be obtained locally, if possible (J.A. 25a), and responsibility should be delegated to a subsidiary commensurate with its ability to operate effectively and profitably. (J.A. 30a)

Despite this management policy, the record reflects that the parent has ultimate control of and constant involvement in the operation of those subsidiaries. Considerable communication between the parent and subsidiaries is evident from the presence of a teletype system and travel of executive personnel of both the foreign subsidiaries and the domestic parent. (J.A. 34a) At top management levels, the taxpayer and its subsidiaries have regular informational exchange, especially with regard to major decisions. (J.A. 35a-36a, 37a) Any sizeable borrowing by a subsidiary requires the approval of the taxpayer. (J.A. 28a) In summary, Woolworth generally oversees the operation of its foreign subsidiaries. (J.A. 49a) These facts, combined with the inclusion of the Canadian, Mexican and German corporations in the taxpayer's consolidated financial statements (J.A. 48a),

indicate that investors are attracted to Woolworth by the impression that Woolworth is a worldwide merchandising operation, and therefore less vulnerable to vacillating regional financial slumps and special local problems. Thus, the business benefit to the taxpayer of its stock ownership is not only the money it receives as dividends, but also the value to Woolworth of the public knowledge that Woolworth is an international retail merchandising operation.

Woolworth's concentration of its sizeable investments is further indication of their business purpose. For example, the relatively small ($64,000) initial investment in its English subsidiary was increased by reinvesting declared dividends into the growing subsidiary, so that now the book value of that investment is approximately $30 million. (J.A. 16a-17a) Investment in the other corporations has increased similarly. (J.A. 18a, 28a, 29a, 31a) Occasional parental loans also aided in the growth of these corporations. (J.A. 28a) These investments required initial management involvement by the parent, which has reduced as those subsidiaries matured and became capable of handling their own affairs. (J.A. 26a) Woolworth's motivation for incurring the risks of financing the establishment of new businesses, rather than choosing a conservative investment, is to obtain profits from the "know-how" acquired in its established merchandising business. The singular fact that many of the management functions have been delegated to subsidiaries does not eliminate the unitary business nature of this series of expansion investments.

In communicating with and overseeing its subsidiaries, the taxpayer incurs significant business expense. For example, the taxpayer maintains a vice-president to act as liaison with the smaller foreign subsidiaries, (J.A. 50a) including the Mexican subsidiary which paid some of the dividends at issue here. Yet Woolworth does not allocate that vice-president's salary, incidental expenses and the cost of his staff as nonbusiness expenses incurred in producing its claimed nonbusiness income. There-

fore, Woolworth is in the untenable position of arguing that its dividend income is nonbusiness income, while at the same time benefitting from its treatment as ordinary business expenses the costs of production of that income. Woolworth's New Mexico tax return also fails to reflect as allocable nonbusiness expenses other expenses related to the production of the income at issue. Unaccounted for are: travel expenses related to attending meetings of the foreign boards (J.A. 16a, 23a, 29a, 39a), the expense of maintaining a teletype system for communicating with foreign subsidiaries (J.A. 34a), the expense of including the Mexican subsidiary in Woolworth's pension plan (J.A. 51a), and the salary and overhead expense related to a foreign exchange hedging investment.[14] (J.A. 53a) Under New Mexico law, a taxpayer is required to allocate and apportion its expenses in the same manner as it does the income to which those expenses relate. Woolworth's failure to reflect these expenses in its allocation (J.A. 57a) underscores the inconsistency between its characterization of its unitary business to this Court and the reality of its day-do-day business conduct.

At the hearing, and in the appellate courts, Woolworth argued that its dividend and foreign exchange income, as nonbusiness income, was allocable to Woolworth's state of commercial domicile, New York. (R. 146) Its present contention that no state has jurisdiction to tax its dividend income and foreign exchange gain is in direct conflict with its prior concession. No New Mexico tribunal was offered the opportunity to consider the implications of Woolworth's present commerce clause argument.

The hearing examiner upheld inclusion in apportionable income of the challenged amounts and found no evidence requiring modification of the formula. This opinion was reversed by the New Mexico Court of Appeals on statutory grounds.

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[14] *See* discussion of the foreign exchange gain, *infra*, at p. 33.

The New Mexico Supreme Court, by writ of certiorari, reversed the Court of Appeals and reinstated the opinion of the hearing examiner, finding that inclusion of the contested amounts was statutorily required, and violated neither the due process nor the commerce clauses of the United States Constitution. The Court found "nothing arbitrary or unreasonable about the Department's conclusion that dividend income is apportionable without modification of the formula" beyond the sales factor modification discussed above, and agreed with the hearing examiner that Woolworth had failed in its burden of showing "clear and cogent evidence" of taxation of extraterritorial values or any "evidence upon which further adjustments could be predicated under the relief provisions of UDITPA." (J.S.A. 21a)

SUMMARY OF ARGUMENT

1. The Due Process Clause, and Apportionment of Dividends and Other Intangible Income.

The general principle applicable to this case is that if a business is unitary, and part of it operates within the taxing state, the state may determine the portion of that business's income attributable to the state by application of a formula which reflects the taxpayer's activities within the state compared to its activities everywhere. Such a method is presumed constitutionally valid.

Woolworth fits the description to which the general rule applies. Woolworth operates a unitary business nationwide, which taxpayer admits includes merchandising, intangible investment and lending money to subsidiary corporations. Woolworth contends that its dividend income is different from its other income. This Court in *Mobil* firmly rejected the notion that dividend income received from a business's foreign subsidiary corporations is distinguishable from other business income of a unitary business. The evidence before the Court and the

applicable law clearly indicate that the challenged income is apportionable business income of Woolworth's unitary domestic business.

Only two factual situations require a constitutional exception to the general rule permitting full formulary apportionment: income derived from a business discrete from and unrelated to the taxpayer's business conducted in the taxing state must be excluded from apportionable income; and income attributed to a state through the apportionment formula must not be out of all proportion to values connected with the taxing state. The taxpayer fits within neither exception.

New Mexico has not taxed the income of Woolworth's foreign subsidiaries, and therefore it does not matter whether those foreign subsidiaries conduct a business discrete from Woolworth's business. Woolworth argues that dividends received from its foreign subsidiaries meet the discrete business exception, on the theory that *Mobil* precludes a state from treating such dividend income as apportionable business income unless the corporations paying the dividends constitute an integral part of the unitary business of the taxpayer. The substance of Woolworth's contention is that dividend income may be taxed by a state only if that state has jurisdiction to tax the payor of the dividends. The case law, however, is clear that dividend income is distinct from the income of the underlying corporation, and may be separately taxed. Intangible assets themselves give rise to income, which is taxable by reference to the activities of the recipient. There is no logical reason for treating this income differently from any other income of the unitary business.

The foreign exchange gain is analogous to any other income Woolworth receives from investing in intangibles. Woolworth's activities in earning the foreign exchange gain are closely analogous to its commercial paper investments, which it concedes produce business income. The record reveals no facts justifying a due process exclusion of this income from apportionable business income.

Nor has Woolworth established that it fits within the second exception to the general rule: that formulary apportionment of Woolworth's income results in taxation out of all proportion to its activities and values in New Mexico. No evidence was introduced to show overreaching by New Mexico, and it is difficult to conceive what evidence might show a tax of $20,000 to be excessive in light of Woolworth's enormous holdings of tangible property in New Mexico, its large New Mexico payroll, and the $13 million in gross receipts Woolworth earned in New Mexico during the relevant tax period.

Despite this Court's steadfast requirement that a taxpayer must produce clear and cogent evidence to overcome the presumption of validity of formulary apportionment, Woolworth seeks a finding of *per se* invalidity because of the large percentage of its income attributable to dividends. The taxpayer's argument depends upon its assumption that inclusion of dividends in apportionable income is equivalent to inclusion of the profits of the payor corporations. New Mexico has not taxed the income of the foreign corporations, but only that of the domestic Woolworth corporation. Therefore, no violation of the due process clause has occurred, and accordingly no adjustment to the apportionment formula is required.

2. The Due Process Clause and Section 78 Dividends.

Woolworth maintains that New Mexico is constitutionally required to grant it a deduction from taxable income for the amount it included in its federal taxable income under section 78 of the Internal Revenue Code (gross-up). New Mexico defines taxable income by reference to federal taxable income. In the case of a multistate taxpayer, the amount it reports as federal taxable income and the amount it must report as apportionable business income are the same unless the taxpayer shows part of the income to be nonbusiness income. New Mexico included this amount in Woolworth's taxable income because Woolworth

included it in Woolworth's federal taxable income. This same reliance on federal taxable income is evident in the taxation statutes of many states.

Section 78 of the Internal Revenue Code requires a domestic corporation which elects to take a credit pursuant to section 902 of the Code for taxes paid by its foreign subsidiary to recognize increased dividend income. The amount which the taxpayer must recognize is treated as income for purposes of other sections of the Code. The legislative history of section 78 indicates that Congress intended to require the recognition of additional income by domestic corporations claiming this foreign tax credit.

Woolworth's only argument in support of its contention that the inclusion of section 78 dividend income violates the due process clause is that "gross-up" is not income within the meaning of the sixteenth amendment. The states, of course, are not governed by the sixteenth amendment but by the due process clause. The taxpayer has not met its burden under the due process clause of showing that the tax imposed by New Mexico is out of all proportion to values connected with the taxing state.

3. The Foreign Commerce Clause

Woolworth's foreign commerce clause argument is premised entirely on *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), a case which differs so radically from the facts at hand that, as this Court held in *Mobil,* any reliance on it is "forced."

Woolworth has nonetheless attempted to revive the *Japan Line* argument and to avoid the *Mobil* precedent by changing one fact. Throughout the course of this litigation, Woolworth has consistently conceded that its dividend income and foreign exchange gain were allocable to New York, its state of commercial domicile. After *Mobil* so conclusively disposed of any

foreign commerce clause argument in the instance where the taxpayer concedes that *some* state has a right to tax income, Woolworth changed its position. Woolworth now maintains that the dividends it received from foreign corporations are not taxable by any state. However, retraction of this concession is insufficient to distinguish Woolworth's commerce clause argument from Mobil's. Like Mobil's, Woolworth's income from its intangible investments is subject to tax by at least one state because the income is earned by activities in the United States. Accordingly, Woolworth cannot avoid the holding in *Mobil.*

Japan Line addressed the taxation of foreign commerce, which the taxpayer here admits is only involved if New Mexico's tax reaches income generated from activities abroad. Since New Mexico's tax is properly apportioned to reflect only activities within New Mexico, the foreign commerce clause is not relevant. Finally, Congress has not prohibited the states from taxation of an apportioned share of a United States domiciled corporation's dividends from foreign commerce; in fact congressional policy permits taxation of the foreign source dividends.

ARGUMENT

I. NEW MEXICO'S INCLUSION OF DIVIDENDS AND FOREIGN EXCHANGE GAIN IN APPORTIONABLE INCOME COMPLIES WITH THE DUE PROCESS RESTRICTIONS ON STATE TAXING POWERS.

Woolworth challenges the power of New Mexico to include income in the form of dividends from foreign subsidiaries in apportionable income. This Court, in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980), has

already held that the inclusion of dividend income received from foreign subsidiaries in the apportionable business income of a domestic taxpayer conducting part of its unitary business in the taxing state does not violate due process. The question addressed by the Court in *Mobil* was "whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad that precludes, as a constitutional matter, state taxation of that income by the apportionment method." 445 U.S. at 435. The Court found no special characteristics prohibiting states from including dividends from foreign subsidiaries in the apportionable tax base.

New Mexico contends that Woolworth's dividend income is properly apportionable because it is part of the business income derived from the operation of Woolworth's domestic unitary business, and therefore meets the due process standards for apportionability. No further adjustments to the apportionment formula are necessary, because Woolworth has not shown that application of New Mexico's apportionment formula to Woolworth's unitary business income results in attribution of income to New Mexico out of proportion to Woolworth's New Mexico activities and properties.

A. The Dividends Received by Woolworth from Its Foreign Subsidiaries Are Income Received by Woolworth in the Conduct of the Ordinary Business Affairs of Its Unitary Business.

The parties have no disagreement as to the boundaries of Woolworth's unitary business. Both the taxpayer and New Mexico describe Woolworth as operating a unitary business in the fifty states, Puerto Rico and the Virgin Islands. The controversy here is limited to the question of whether the substantial income received by this taxpayer as dividends from its

foreign subsidiaries is part of the taxpayer's unitary business income[15] and therefore apportionable.

The New Mexico Supreme Court found that the dividend income from Woolworth's stock investments was business income.[16] This finding is supported by the facts in the record:[17]

- The taxpayer has a substantial number of investments in subsidiaries conducting Woolworth merchandising operations very similar to its own. The existence of Woolworth stores worldwide is an obvious business benefit to Woolworth and indicates that investment in these subsidiaries was motivated by business considerations. The taxpayer's management is actively involved in overseeing the activities of those subsidiaries, insofar as important decisions are concerned.[18]

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[15] A finding that income of a multistate business is "business" income under UDITPA is equivalent to a finding that it is income to a unitary business and therefore apportionable according to the unitary business principles, discussed *infra*, at p. 20 *et seq. See Tipperary Corp. v. New Mexico Bureau of Revenue*, 93 N.M. 22, 595 P.2d 1212 (Ct.App. 1979), *cert. denied* 92 N.M. 675, 593 P.2d 1078 (1979); *Albany Int'l Corp. v. Halperin*, 388 A.2d 902 (Me. 1978); *Montgomery Ward & Co. v. Commissioner of Taxation*, 276 Minn. 479, 151 N.W.2d 294 (1967); *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979).

[16] "The income arose from activities of Woolworth in the regular course of its business. The income was acquired and managed as an integral part of its regular business operations. §7-4-2(A). The purpose for acquiring and holding the stock is related to its business operations N.M. Ind. [*sic*] Tax Regulation 17(a). The three-prong *Tipperary* test of Judge Wood is fully met by the evidence in favor of apportionability." (J.S.A. 14a)

[17] The facts described below are discussed in greater detail in the Statement of the Case, *supra*, pp. 1-10, wherein citations to the record are provided.

[18] *See Xerox Corp. v. Comptroller of Treasury*, 290 Md. 126, 428 A.2d 1208 (1981).

- The taxpayer issues a consolidated financial statement in its Annual Report including three of the four subsidiaries in question here, thereby utilizing these assets to help insure available capital from potential Woolworth shareholders.[19]

- The taxpayer commingles the income received as dividends from these investments in its general treasury; no evidence in the record contradicts the reasonable conclusion that the dividends are used by the corporation to pay its general business expenses.[20]

- The taxpayer incurs substantial expense in communicating with and overseeing its foreign investments, and has not shown that it treats these expenses as nonbusiness expenses.[21]

- The corporate management of Woolworth participates in managing the foreign subsidiaries, at the board of directors level, and chooses the individuals who actually manage the subsidiaries.

- The taxpayer concedes that part of the ordinary business operations of the taxpayer include investing in intangibles such as commercial paper and treasury notes, and that making loans is also a part of its regular trade or business activities.

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[19] *See W. R. Grace & Co. v. Commissioner of Revenue*, 378 Mass. 577, 393 N.E.2d 330 (1979).

[20] Commingling income from a particular activity with general business income is some indication that the taxpayer considers all the income to be business income, especially when expenses related to the item of activity are deducted as business expenses, for federal income tax reporting purposes. *See Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789 (Ky. Ct. App. 1981); *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979).

[21] Under UDITPA, a taxpayer allocating nonbusiness income must accordingly allocate any corresponding nonbusiness expenses. New Mexico Income Tax Regulation 17c. (R.130)

Absence of evidence in the record indicating that the income was earned in a separate business is also significant.[22]

It is not a new or unusual concept to view investments as an integral part of a taxpayer's business:

> Nor can it be justly said that investments have no real relation to the business transacted by a corporation. The possession of large assets is a business advantage of great value; it may give credit which will result in more economical business methods; it may give a standing which shall facilitate purchases; it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige.

Flint v. Stone Tracy Co., 220 U.S. 107, 166 (1911).

Woolworth unrealistically maintains that its business consists solely of its merchandising activities. The record reflects several Woolworth activities producing income in 1976: operating its domestic retail stores; owning and actively overseeing the substantial stock investments producing the dividend income in dispute; speculating on the foreign exchange; lending money; investing in commercial paper. Several of these activities produce income from intangibles. The record contains no factual basis for distinguishing taxpayer's dividend income from its stock investments from its other income from intangibles, and Woolworth cites no authority for such a distinction.

At the evidentiary hearing, Woolworth made no attempt to show that its investment activities were not part of its business, but concentrated its efforts on showing that Woolworth was not functionally integrated with its foreign subsidiaries, a showing New Mexico contends is irrelevant to the question of whether Woolworth's intangible investments are part of its unitary

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[22] Since it is a taxpayer's burden to show that some of its activities are part of a discrete business enterprise or done for a nonbusiness purpose, *Mobil*, 445 U.S. at 439, the absence of evidence in the record allows us to assume the necessary unity.

business. *See In Re Goodyear Tire & Rubber Co.*, 133 Vt. 132, 335 A.2d 310, 311-312 (1975).

Developing jurisprudence in the recent state court opinions on the question of investment income apportionability is consistent in allowing full apportionability of income from intangibles, if the intangible investments are part of a taxpayer's business, without regard to whether the business underlying the intangible investments is actually unitary with the investor. *See W. R. Grace & Co. v. Commissioner of Revenue*, 378 Mass. 577, 393 N.E.2d 330 (1979) (focusing on the purpose of taxpayer's investment in a beer brewing company to find the stock part of taxpayer's chemical business); *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979) (finding loans to subsidiaries to be an integral part of a taxpayer's merchandising business); *Xerox Corp. v. Comptroller of Treasury*, 290 Md. 126, 428 A.2d 1208 (1981) (finding royalty and interest income to be unitary business income without regard to relationship with payor). *Accord, Montana Department of Revenue v. American Smelting & Refining Co.*, 173 Mont. 316, 567 P.2d 901 (1977), *appeal dismissed*, 434 U.S. 1042 (1978) (income from intangible investments, including stock, are part of the unitary business, without regard to whether the payor is part of the recipient's unitary business).[23]

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[23] Other cases including intangible income as apportionable unitary business income, without regard to the unity of the payor's activities with the recipient: *American Smelting & Ref. Co. v. Idaho State Tax Comm'n*, 99 Idaho 924, 592 P.2d 39 (1979), *vacated*, 445 U.S. 939 (1980), *reinstated*, 102 Idaho 38, 624 P.2d 946 (1981); *Albany Int'l Corp. v. Halperin*, 388 A.2d 902 (Me. 1978); *Montgomery Ward & Co. v. Commissioner of Taxation*, 276 Minn. 479, 151 N.W.2d 294 (1967); *Great Lakes Pipe Line Co. v. Commissioner of Taxation*, 272 Minn. 403, 138 N.W.2d 612 (1965), *appeal dismissed*, 384 U.S. 718 (1966); *Champion Int'l Corp. v. Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App. 1975); *Sperry & Hutchinson Co. v. Department of Revenue*, 270 Or. 329, 527 P.2d 729 (1974); *In re Goodyear Tire & Rubber Co.*, 133 Vt. 132, 335 A.2d 310 (1975);

(Cont. p. 20)

B. Due Process Is Not Violated by the Inclusion of Dividends in Woolworth's Apportionable Business Income.

The growing presence of multistate and multinational businesses doing business in the individual states has caused special challenges to each of those states in devising equitable and practical methods of taxing, so as to obtain from these enterprises a return reasonably related to "opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). The task of the state government is particularly difficult, given the increasing complexity in business relationships and the diversity of interrelated business enterprise conducted.[24] Recognizing the needs of the states, this Court has been reluctant to interfere with state methods of taxation, unless it is proven by clear and convincing evidence that the state's taxing scheme violates the "extremely limited restrictions that the Constitution places upon the states." *Id.* at 445. *See Bass, Ratcliff & Gretton, Ltd., v. State Tax Commission*, 266 U.S. 271 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

There are two "extremely limited restrictions" imposed by the due process clause. First, there must be some minimal connection between the activities of the interstate business and the taxing state. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267

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23 (Cont. from p. 19)
F. W. Woolworth Co. v. Commissioner of Taxes, 130 Vt. 544, 298 A.2d 839 (1972); *Gulf Oil Corp. v. Morrison*, 120 Vt. 324, 141 A.2d 671 (1958); *Corning Glass Works v. Department of Revenue*, 616 S.W.2d 789 (Ky. Ct.App. 1981).

24 *See* Corrigan, Schoettle & Dexter, *The Search for Equity and Accountability in State and Local Taxation of Multistate-Multinational Corporations*, 12 URB. LAW. 553 (1980); Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976).

(1978); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980). The minimal connection necessary is satisfied if the business being taxed carries on its business within the state. *Wisconsin v. J.C. Penney*. If the business being taxed is a unitary one, with operations both within and without the state, nexus is supplied by the presence of part of the unitary business within the state. *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). The second due process requirement is that "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing state.' " *Moorman Mfg. Co. v. Bair*, 437 U.S. at 273, quoting *Norfolk & Western R. Co. v. State Tax Commission*, 390 U.S. 317, 325 (1968). This second requirement is discussed *infra* at p. 25.

Because the taxpayer is a unitary business and conducts part of its business in New Mexico, it cannot avoid the imposition of New Mexico's tax, unless it can show that part of the income included in the apportionment formula is earned by the taxpayer in a business discrete from and unrelated to the business conducted in the taxing state. *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. at 224. In the context of this case, to meet the burden[25] of showing income from a discrete business, Woolworth would have had to show that the dividend income it wished to allocate arose from a business separate from the unitary merchandising business operating in the taxing state.[26]

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[25] The burden of showing that income is derived from a discrete business enterprise not connected with the taxing state is on the taxpayer. *Exxon Corp. v. Department of Revenue*, 447 U.S. at 224.

[26] Woolworth's concession that a securities dealer's dividend and interest income may be apportionable business income cannot be reconciled with its contention that due process requires functional integration of a foreign corporation and its domestic shareholder as a condition precedent to the apportionability of income. *See Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *Johns-Manville Products Corp. v. Commissioner of Revenue*, 115 N.H. 428, 343 A.2d 221 (1975), *appeal dismissed*, 423 U.S. 1069 (1976).

Woolworth attempts to do this by arguing that the dividends are attributable to the separate businesses of its foreign subsidiaries, relying on *Mobil* for the proposition that dividends may not be included in apportionable net income of the recipient unless the subsidiary or affiliated corporation in which the stock is held is a functionally integrated part of the unitary business being conducted partially within the taxing state. (Brief of Appellant at 14)[27]

The taxpayer's reading of the Court's holding in *Mobil* is incorrect. As the Court stated, the issue in *Mobil* was whether, where most[28] of the dividend paying corporations were in fact engaging in business activities forming part of Mobil's unitary petroleum enterprise, dividends received by the parent were includable in apportionable business income. *Mobil,* 445 U.S. at 439. The Court expressly refused to decide whether such dividends would be includable, if the business of the payor had "nothing to do with the activities of the recipient." *Mobil,* 445

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[27] The taxpayer also relies heavily on the case of *Square D Co. v. Kentucky Board of Tax Appeals,* 415 S.W.2d 594 (Ky. 1967), as support for its theory that dividends may not be part of business income unless the payor and the payee are unitary. *Square D* has no remaining vitality in light of *Corning Glass Works v. Department of Revenue,* 616 S.W.2d 789 (Ky. Ct.App. 1981), wherein the court found income from capital gains, interest and royalties to be part of the regular business income of the taxpayer, and therefore apportionable in compliance with due process, and refused to follow its prior holding in *Square D,* distinguishing that case on the ground that the statute construed in *Square D* had been amended, and ignoring the constitutional analysis in *Square D.* 616 S.W.2d at 794. Thus, *Square D* may no longer be relied upon in support of Woolworth's constitutional arguments.

[28] Another indication that the Court in *Mobil* did not intend to limit dividend apportionability to situations where a dividend payor is functionally integrated with its owner is the fact that it found apportionable the dividends paid to Mobil by ARAMCO, of which Mobil owned only 10 percent of the capital stock. *Mobil,* 445 U.S. at 430 n.5. This limitation on ownership would seem to preclude a finding of unity.

U.S. at 442. Moreover, the Court made no mention of the case where the taxpayer's investment in the dividend paying corporations contributes to and enhances the value of the taxpayer's business, but such corporations are not a unitary part of the taxpayer's business. Since neither of these two factual situations was before the Court, it cannot be said that *Mobil* determined the constitutionality of including dividends in apportionable business income in those situations.

The Court in *Mobil* expressly cited and reaffirmed prior case law on the subject of state taxation of a unitary business, and addressed the question of whether there is something about the nature of dividend income that distinguishes it from other business income. *Mobil*, 445 U.S. at 440. The Court answered that question in the negative. It certainly required no deviation from precedent to find, where the taxpayer had actually invested its money to acquire ownership in companies which directly assisted Mobil in completion of the goals of its business, that the income from its investments was part of its unitary business.

The extension of *Mobil* that Woolworth advocates would require the Court to overrule precedents of long standing which have neither been eroded nor even questioned by this Court up until now. This taxpayer urges the Court to hold that stock dividends received by a domestic corporation from a foreign corporation may not be included in apportionable business income unless the payor is unitary with the payee. A necessary corrollary to such a holding would be that the dividend income is attributable to activities of the payor, rather than to investment activity of the recipient. The Court has recognized that "the property of the shareholders in their respective shares is distinct from the corporate property, franchises and capital stock, and may be separately taxed." *Hawley v. Malden*, 232 U.S. 1, 9 (1914). "When we are dealing with the intangible interests of the shareholder . . . the jurisdiction to tax it is not dependent upon the location of the lands and chattels of the corporation." *Hawley v. Malden*, 232 U.S. at 11. Again, in

Klein v. Board of Tax Supervisors, 282 U.S. 19 (1930), this Court, speaking through Mr. Justice Holmes, based its decision affirming the power of the state to tax holders of stock upon the difference between ownership of stock in a corporation and ownership of the corporation itself. "There is no doubt that a state may tax a corporation and also tax the holders of its stock. [Citation omitted.] The owners are different and, although the appellant calls it a mischievous fiction, the property is different." 282 U.S. at 23. Whatever the relationship between a corporation and the holder of its stock, it is well established that, with only limited exceptions, the two are separate taxable entities. *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949); *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943). Shares of stock are intangible property, that is, "rights which are not related to physical things." *Curry v. McCanless*, 307 U.S. 357, 365 (1939). They are the property giving rise to income to their owners. "The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members." *Klein v. Board of Tax Supervisors*, 282 U.S. at 24. The doctrine addressed in these cases has impact, not only in taxation, but in many other areas of the law. The legal conclusion urged by the taxpayer is not warranted by this Court's finding in *Mobil*, and would have implications far beyond the issues addressed in this case.

What the Court actually did in *Mobil* was in accord with its traditional role in state tax cases: it examined a state taxing scheme to determine whether any clear constitutional violations were apparent in the operation of the tax. *See Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940). Woolworth argues that *Mobil* establishes affirmative state taxation guidelines, although such action is not in keeping with this Court's prior decisions. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). This Court has repeatedly refused to substitute its own judgment for that

of the state legislature;[29] instead, it has presumed the state scheme valid, unless shown by clear and convincing evidence that it violates some constitutional prohibition. This is all the Court did in *Mobil.*

C. Because New Mexico Has Not Included the Income of the Subsidiary Corporation in Woolworth's Apportionable Business Income, Due Process Requires No Adjustment to the Apportionment Formula.

Although the taxpayer has $8.75 million of tangible property located in New Mexico, meets a New Mexico payroll of almost $2 million and derives gross receipts from New Mexico of more than $13 million, it contends that formulary attribution of $402,000 of its income to its New Mexico operation constitutes a *per se* violation of due process. The actual tax New Mexico imposed on that income is miniscule. It amounts to only about $20,000, or .175 percent of the taxpayer's gross receipts earned in New Mexico.[30]

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[29] "In the first place, it is doubtful whether any legal test could adequately reflect the numerous and competing economic, geographic, demographic, social, and political considerations that must inform a decision about an acceptable rate or level of state taxation, and yet be reasonably capable of application in a wide variety of individual cases. But even apart from the difficulty of the judicial undertaking, the nature of the factfinding and judgment that would be required of the courts merely reinforces the conclusion that questions about the appropriate level of state taxes must be resolved through the political process. Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress, when particular state taxes are thought to be contrary to federal interests." *Commonwealth Edison Co. v. Montana,* 101 S.Ct. 2946, 2959 (1981) (footnote omitted).

[30] For comparison purposes, it is interesting to examine the alternative method of computing income taxes provided by UDITPA, for a corporation having much less connection with New Mexico than Woolworth. Had

(Cont. p. 26)

1. No Violation of Due Process Has Been Shown.

The New Mexico statute apportions business income on the basis of three factors, similar to those used by Vermont in *Mobil.* If a taxpayer can show that in its case the apportionment factors do not fairly represent the extent of its activities in New Mexico, it may seek adjustment of the formula, so as to effectuate a reasonable attribution of income. Section 7-4-19 NMSA 1978. Woolworth, however, presented no evidence showing either that the amount of income attributed to New Mexico by the formula was unfair, or that another method would be equitable. At the hearing, as in *Mobil,* Woolworth's "principal object was to achieve the subtraction of the asserted nonapportionable income from the preapportionment tax base; the alternative request for modification of the apportionment formula went largely undeveloped." *Mobil,* 445 U.S. at 432. At the end of the hearing, the hearing examiner had no more idea of the specifics of Woolworth's desired formula adjustments than he did at the beginning of the hearing. Consequently, he concluded that Woolworth had not met the statutory burden of showing a "reasonable and specific proposal," and that therefore no factor adjustment was appropriate. (J.S.A. 37a) This conclusion was affirmed by the New Mexico Supreme Court. (J.S.A. 21a)

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30 (Cont. from p. 25)

Woolworth only sales activities attributable to New Mexico, and no property here, it would have been eligible to elect the alternative method of reporting provided in §7-5-2 NMSA 1978. That simple calculation allows such a taxpayer to pay a tax of only .75 percent of its gross sales in New Mexico: the resulting tax liability would be $97,500, almost 5 times the tax liability of which Woolworth now complains. *Cf. Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 280 (1978), wherein this Court noted that the taxpayer would have had no constitutional complaint if the state had imposed a more burdensome gross receipts tax, instead of the income tax of which Moorman complained.

Having thus waived its opportunity under New Mexico's statute to achieve an apportionment adjustment, Woolworth now argues that the adjustment is constitutionally required, because the New Mexico formula is "inherently arbitrary."[31] (Brief of Appellant at 32) Yet the taxpayer does not demonstrate any way in which New Mexico's apportionment formula attributes income to New Mexico " 'out of all appropriate proportion to the business' transacted" by the taxpayer in New Mexico. *Butler Bros. v. McColgan,* 315 U.S. 501, 507 (1942), quoting *Hans Rees' Sons v. North Carolina,* 283 U.S. 123, 135 (1931). Nor is there clear and cogent evidence showing that application of New Mexico's formula led to a "grossly distorted result." *Norfolk & Western R. Co. v. State Tax Commission,* 390 U.S. 317, 326 (1968).

The amounts attributable to New Mexico by the apportionment formula are reasonable in light of the activities of Woolworth in New Mexico. The factors of property, payroll and sales are appropriate ingredients of a formula, and reflect "the relative contribution of the activities in the various states to the production of the total unitary income," thereby allocating to the taxing state a "just proportion" of the profits of a unitary business. *Butler Bros. v. McColgan,* 315 U.S. at 509. It is impossible for a state to include every conceivable factor in an apportionment formula. *Gulf Oil Corp. v. Morrison,* 120 Vt. 324, 141 A.2d 671, 675 (1958). Where an apportionment formula is clearly designed to tax only the proportion of the taxpayer's income reasonably related to its New Mexico activities, the formula should not be overturned absent a factual showing that the amount of tax is unreasonable. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978); *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920).

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[31] Having failed to meet the statutory standard, the taxpayer should not now prevail in its due process contentions. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 275 (1978).

Woolworth contends that its evidentiary burden to show actual taxation of extraterritorial values is met by "the dramatic, nearly five-fold increase in appellant's New Mexico taxable income." (Brief of Appellant at 41) Woolworth's position is akin to the separate accounting analysis consistently rejected by this Court. *Cf. Exxon Corp. v. Wisconsin Department of Revenue,* 447 U.S. 207 (1980) (rejecting separate functional accounting); *Mobil* (rejecting separate geographical accounting). By identifying the "source" of certain income, Woolworth says it can show that amount not to be related to New Mexico. Woolworth then presumes the point that it wishes to prove: that the dividend income does not represent business income, and that only the amount remaining after subtraction of the dividend amount represents business income. This subtraction proves only that Woolworth's tax liability to New Mexico would be substantially less, if New Mexico did not include dividends in apportionable business income. *See Moorman,* 437 U.S. at 275 n. 9. As this Court pointed out in *Mobil,* "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." 445 U.S. at 438. Woolworth contends that New Mexico is limited to taxing only income attributable to Woolworth's activities in New Mexico. (Brief of Appellant at 33) However, the record shows almost nothing about the nature or extent of taxpayer's activities in New Mexico or the amount of income earned from those activities, other than that it operates a Woolworth store in Santa Fe (J.A. 20a), and that it has extensive property, payroll and sales located in New Mexico. (J.A. 57a) Woolworth's activities in New Mexico may very well produce the amount attributed here by formula, or even more; the total amount of income attributable to New Mexico by formula is only about three percent of its New Mexico gross receipts. *See Moorman,* 437 U.S. at 276. Besides, where the New Mexico business is an integral part of a much larger business, Woolworth's nationwide unitary business, it becomes irrelevant to

attempt to break out amounts attributable to only one activity of the unitary business. Every aspect of the business contributes to the production of income; the larger and more prosperous a business is, the more able it is to make advantageous use of the privileges and protections provided in a single state. *Ford Motor Co. v. Beauchamp,* 308 U.S. 331 (1939). Thus, the mere fact that the amount of income attributable to New Mexico is greater, because the unitary business receives substantial amounts of income from its intangibles investments, does not prove that the apportionment formula is inherently arbitrary.

Woolworth contends that New Mexico's apportionment statute violates due process because it attributes differing amounts of income to New Mexico, depending merely on the corporate structure of the taxpayer. (Brief of Appellant at 33) The facts do not support this contention. The unitary business taxed here does not operate through either divisions or subsidiaries. The single corporation and the unitary taxpayer in this case have identical boundaries. The taxpayer's foreign subsidiaries are not taxed as part of the unitary taxpayer.[32]

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[32] If the foreign subsidiaries were, instead, corporate divisions, there is no indication that New Mexico would automatically include them as part of the unitary taxpayer, as Woolworth assumes in its argument. Assuming that all other facts remained the same, the foreign divisions would not be included as part of the unitary taxpayer, because a mere change in the corporate structure of the taxpayer without more indicates nothing concerning the boundaries and number of unitary businesses being conducted. *Cf. Exxon.* Moreover, had Woolworth considered its foreign subsidiaries to be an integral part of its business operations, it could have included them in its business, for tax purposes, and thereby achieved the recognition in the apportionment factors of the activities of the foreign corporations that Woolworth argues is necessary. (Brief of Appellant at 36) New Mexico allows the use of combined reporting, when a unitary business is conducted by more than one corporation. (R. 49; New Mexico Income Tax Regulation 18(b)(2) at R. 130) In a combined report, the net business income is the combined income of each corporate member of the unitary group, except that intercorporate transactions are eliminated from the total income. The three factor formula includes the property, payroll and

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2. The Taxpayer Offers No Acceptable Alternative to New Mexico's Formula.

Woolworth has consistently disclaimed any contention that its foreign subsidiaries are part of its unitary business, and announces its agreement with the argument that worldwide combination cannot be required. (Brief of Appellant at 37) The formula adjustment Woolworth requests, however, is a hybrid utilizing a combination of factors in the apportionment formula, but no combination of the income of the separate corporations, in effect apportioning the income of the smaller business, the domestic unitary business, with reference to the location and reach of a much larger business, a worldwide unitary business.[33]

The taxpayer's contention that its proposed formula is constitutionally mandated lacks precedent.[34] While this Court

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32 (Cont. from p. 29)
sales of each member of the business. For a fuller explanation of the combination method, *see* Corrigan, *Mobil-izing Interstate Taxation,* XIII TAX NOTES, No. 15, October 12, 1981.

33 The taxpayer seems to change position, in its apportionment argument, and seems to indicate that the taxpayer is operating a unitary business with its subsidiaries. (Brief of Appellant at 33)

34 Commentators have proposed various methods of adjusting the apportionment formula when intangible income is to be apportioned. *E.g.,* Keesling, *The Impact of the Mobil Case on Apportionment of Income,* 1981 B.Y.U. L. REV. 87; Dexter, *Tax Apportionment of the Income of a Unitary Business: An Examination of Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 1981 B.Y.U. L. REV. 107; Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076,* 79 MICH. L. REV. 113, 128 (1980); Peters, *Supreme Court's Mobil Decision on Multistate Income Apportionment Raises New Questions,* 53 J.TAX 36, 39 (1980). The task of the states is to determine which, if any, of the proposals result in a fair determination of the value to a taxpayer of doing business in a taxing state. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978). This Court's function is to guard the outer limits and prevent a state from overreaching. *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435 (1940).

has found that application of a particular formula violates due process in individual cases,[35] the Court has never departed from

> the basic principles that the States have wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' . . . or has 'led to a grossly distorted result.' [Citations omitted.]

Moorman, 437 U.S. at 274.

Here, as in *Moorman*, to adopt Woolworth's proposed formula adjustment would require "extensive judicial lawmaking," 437 U.S. at 278[36] and in this case would be based exclusively on hypothetical facts. Nothing could be further from the role defined by the Court for itself in state tax cases.

The proposed apportionment formula is unacceptable not only because Woolworth has failed to meet its heavy evidentiary burden, but also because it is based on unsupportable assumptions. The taxpayer assumes that including dividends in apportionable income is the same as including the income earned by a subsidiary corporation, which would justify factor adjustments. This assumption is incorrect because the rights to receive the two different types of income arise from different types of relations to property, *see* discussion *supra* at 23, and also because the amount of dividends distributed has no necessary relation to the amount of income earned by a corporation. A corporation is under no obligation to distribute all its income as dividends in any year, and may distribute income although it earns no income in a given year.

Also, Woolworth implicitly assumes that income in the form of dividends is intrinsically different from other income from

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[35] *E.g., Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931); *Norfolk & W.R. v. State Tax Comm'n*, 390 U.S. 317 (1968).

[36] *See also Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940).

intangible properties. Although Woolworth concedes that it obtains ordinary business income in the form of interest, it makes no attempt to include in its apportionment formula the factors of the corporations (including its Canadian subsidiary) paying the interest. Although it concedes that it obtains ordinary business income from its investments in commercial paper and treasury notes (J.A. 27a), it makes no attempt to include the factors of the obligors under those notes. It offers no explanation why dividend income, arising from the recipient's legal rights as a purchaser of shares, should be treated differently.

It is interesting that Woolworth should rely on *People ex rel. Alpha Portland Cement Co. v. Knapp*, 230 N.Y. 48, 129 N.E. 202, 181 N.Y.S. 32 (1920), for its argument that factors of payor corporations must be included in an apportionment formula. That case does not support inclusion in the factors of the location of the payor, but rather inclusion of the location of the shares in the apportionment formula. Since intangible properties have no real location apart from the location of their owner, the philosophy underlying Judge Cardozo's opinion is consistent with New Mexico's contention that dividend income may be apportioned just as any other item of ordinary business income. The location of business intangibles is "wherever its tangible property is located and its work is done." *Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185, 223 (1897); *Curry v. McCanless*, 307 U.S. 357 (1939).

Woolworth hopes for a second opportunity to present evidence of appropriate factors to be used in the apportionment formula, and reserves its right to object to any factors used in the apportionment formula. To paraphrase this Court, the Supreme Court of New Mexico "created no innovation and sprung no surprise when it placed on appellant the burden of establishing that the formula taxed extraterritorial values. As we have noted, that is settled doctrine." *Butler Bros. v. McColgan*, 315 U.S. at 510. It is fair to assume here, as in

Mobil, that the evidence, if presented, would not have supported Woolworth.

D. Foreign Exchange Gain Is Apportionable Business Income of Woolworth.

The taxpayer argues in a footnote that the foreign exchange gain it realized from a hedging transaction should be considered as identical to any dividends received from its English subsidiary, and that exclusion of those amounts from apportionable business income is therefore appropriate. (Brief of Appellant at 25 n. 12) Neither logic nor the evidence supports Woolworth in this argument.

Nothing in this record indicates that Woolworth's income from its hedging transaction is so inextricably related to its dividend income from its English subsidiary as to be inseparable for taxing purposes. Details of the transaction were not presented by Woolworth; the hypothetical situation described by the taxpayer's witness, Mr. Feeley, is inconsistent with the mechanism described by the taxpayer in its brief.[37] Apart from this inconsistency, little may be gleaned from the record concerning the nature of this item of income. Surely, the mere fact that

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[37] The hearing examiner heard testimony that would seem to indicate that the gain was received because of an increase in the ratio of dollars to pounds, by virtue of the testimony of Mr. Feeley: "We give them [the pounds] to them [the purchaser] at the stated price which we receive a dollar ninety-five for. At the same time the English company, then, disburses the pound to us and perhaps the market conditions are such that we can make fifty cents profit on the pound so that we will be getting two fifty. So, that is how a profit would arise." (J.A. 53a)

In appellant's brief, however, the reverse is asserted: "If the dividends were worth more in dollars when received than they were when declared, appellant's hedging transaction would result in a foreign exchange loss, and *vice versa*." (Brief of Appellant at 26 n. 12)

the pounds received in one transaction as dividend receipts are obligated, at least in part, to fill another contract for sale of pounds is insufficient support for the conclusion that proceeds from the two transactions are indistinguishable for state income tax purposes. The taxpayer has failed to meet its burden of showing that its income attributable to a foreign exchange gain is not part of the unitary business income includable in the apportionable business income pool.

Assuming that Woolworth entered into a true hedge, *see, e.g., Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1955), and that its decision to do so may have been motivated by Woolworth's concern that fluctuating exchange rates would adversely affect the amount of dividends received from its English subsidiary, it does not follow that income from the hedging transaction arises from the same source as a dividend. The taxpayer itself arranges for the contract with a third party to sell a set number of pounds for a set number of dollars on a certain date.[38] The complicated calculations necessary to determine the desirability of a hedge[39] were most probably performed by financial managers employed by the party desiring to hedge – i.e., Woolworth. Someone on the payroll of Woolworth made the financial decision. Woolworth was the beneficiary of the contract and had the obligation to perform under the contract. In short, this hedging investment is no different from Woolworth's commercial paper investments, which it has conceded to be part of its business. In the absence of a showing by the taxpayer that the income is from a discrete business

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[38] Polk, *Financial and Tax Aspects of Planning for Foreign Currency Exchange Rate Fluctuations,* 56 TAXES 131, 135 (1978).

[39] *See* Costello, *Tax Consequences of Speculation and Hedging in Foreign Currency Futures,* 28 TAX LAW. 221, 240-242 (1975).

activity, it is a part of the unitary business carried on in New Mexico.[40]

II. THE INCLUSION OF SECTION 78 INCOME IN APPORTIONABLE BUSINESS INCOME DOES NOT VIOLATE DUE PROCESS.

New Mexico, as do many other states, measures its income tax by the amount reported by a taxpayer on its federal return as federal taxable income. Section 7-2-2(S) NMSA 1978. Woolworth indicated on its federal return that its taxable income was $88 million. Nonetheless, it seeks to exclude from its New Mexico taxable income base $25.5 million of its federal taxable income included pursuant to section 78 of the Internal Revenue Code. New Mexico submits that Woolworth's federal taxable income is a fair approximation of this taxpayer's unitary business income.

To succeed the taxpayer must prove that the state's reliance on federal taxable income results in taxation of an amount which bears no rational relationship to "values connected with the taxing state," *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978), or which has no "nexus" with the state. *Mobil*, 445 U.S. at 437. A state may devise any reasonable scheme for determining taxable income; New Mexico has chosen to rely on federal taxable income as a reasonable approximation of a

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[40] Even if taxpayer's assertion – that the transactions were not "independent, speculative investment" (Brief of Appellant 26 n. 12) – had been established by the facts, the implications do not support Woolworth. In the federal tax scheme, the problem addressed by characterization of a transaction as a "hedge," rather than as an "independent, speculative investment," is the question of whether the gain or loss is capital or ordinary. If the transaction is a true "hedge," the income or expense is ordinary, because "a hedge has always been viewed as a means of protecting ordinary operating profits realized in the day-to-day operation of the business enterprise." *Hoover Co. v. Commissioner*, 72 T.C. 206, 238 (1979).

taxpayer's apportionable business income.[41] The constitutional test is not whether New Mexico's tax is imposed on "income," as used in the sixteenth amendment.[42] Discussion of whether an item is truly "income" is irrelevant to consideration of the due process limitations imposed on a state's power to tax, and Woolworth has not shown that due process is violated by inclusion of the gross-up dividend amount. *See* Section I, *supra.*

In any event, Woolworth's characterization of gross-up income as nothing more than "one part of a computational formula" (Brief of Appellant at 28) does not withstand analysis. The requirement that a taxpayer "gross-up" income is a logical part of the federal scheme for taxing entities which do business abroad. Sections 901 and 902 of the Internal Revenue Code address two basic situations in which a domestic corporation receives income from its operations abroad. Where the domestic corporation operates abroad through a foreign division, the taxpayer declares the total of the division's income, but is allowed a credit against the United States' tax for taxes it paid

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[41] Federal taxable income is itself an approximation. Examination of each item included in and subtracted from gross income in order to arrive at federal taxable income reveals more about federal tax policy than it does about a taxpayer's "real" economic income. Deductions and credits may reflect current federal economic policies; for example, the recently adopted Accellerated Cost Recovery System, Pub. L. No. 97-34, §201(a), 95 Stat. 204 (1981) (to be codified in I.R.C. §168), which applies accellerated methods of cost recovery over statutory periods, will result in a decrease in federal taxable income, although a taxpayer's real economic income may remain the same.

[42] The sixteenth amendment does not affect the state's right to tax. Since the sixteenth amendment expressly authorized Congress to impose taxes only on income, this Court has been required to address the question of the nature of income, in a constitutional sense, in determining whether a tax is constitutionally permitted to the federal government. This is all the Court determined in *Eisner v. Macomber,* 252 U.S. 189 (1920), and *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955). These constitutional limitations do not apply to the states.

to a foreign government. I.R.C. §901. Where the corporation operates abroad through a foreign subsidiary, the parent corporation may elect to claim a credit for a proportionate amount of the taxes paid by the foreign subsidiary to a foreign country. I.R.C. §902. Through section 902(a), Congress has extended "the same tax treatment to a domestic corporation with a foreign subsidiary as is accorded a domestic corporation with a foreign branch within the same corporate shell." *Associated Telephone & Telegraph Co. v. United States,* 306 F.2d 824, 832 (2d Cir. 1962). If the domestic parent corporation chooses to take the foreign tax credit under section 902, it must increase or "gross-up" its taxable income by an amount equal to the foreign taxes paid by the foreign subsidiary. I.R.C. §78.

Prior to the enactment of section 78 in 1962,[43] section 902 in effect gave both a deduction and a credit for the foreign tax, in that the dividends on which the domestic corporation paid the tax did not include the amount of the income of the foreign corporation used to pay the foreign tax. H.R. REP. No. 1447, 87th Cong., 2d Sess. 50 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 66 (1962). *See* 5 MERTENS, LAW OF FEDERAL INCOME TAXATION §33.14 (Repl. Vol. 1980); Bodner & Shapiro, *The Fundamentals of the Foreign Tax Credit,* 47 TAXES 424, 426 (1969).[44] The practical effect of this was that

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[43] The gross-up provision was added by Pub. L. No. 87-834 §9(b), 76 Stat. 1001 (1962).

[44] A domestic corporation operating abroad through a branch was subject to United States tax on the entire amount of its earnings abroad, with the foreign tax credit applicable to the United States tax. In contrast, a taxpayer operating abroad through a subsidiary would receive an amount as a dividend from which the foreign taxes had already been subtracted (the "deduction" for foreign taxes) and was then also allowed the foreign tax credit. The House and Senate both prepared charts which were illustrative of the tax differential which resulted from the omission of this amount, stating that "[t]he tax differential represents the difference between the U.S. and foreign tax rates, multiplied by the income omitted from the U.S. tax base." H.R. REP. No. 1447, 87th Cong., 2d Sess. 51 n. 3 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 67 n. 3 (1962).

"the full U.S. tax [was] not paid on most dividend income received by domestic corporations from foreign corporations." S. Rep. No. 1881, at 68.

Section 78 rectified this situation by requiring that a taxpayer electing the foreign tax credit "increase, or 'gross-up,' his U.S. tax base by including in it the amount of foreign income paid in taxes which is attributable to the dividend received." H.R. REP. No. 1447, at 52.[45] The legislative history of section 78 demonstrates that Congress intended to require domestic taxpayers to increase the amount of income they recognized from their operations abroad. The enactment of section 78 does not simply generate a number against which a credit can be taken. As the House and Senate Committees noted, the recognition of section 78 dividend income results in the treatment of that amount as income for purposes of other sections of the Code:

> The amount included in gross income by operation of section 78 is treated as a dividend in the same manner as a dividend actually received by the domestic corporation from a foreign corporation. For example, a section 78 dividend is included in gross income under section 61(a)(7); is personal holding company income for purposes of section 543(a)(1); and may be a portion of accumulated taxable income for purposes of section 535. However, a section 78 dividend is not a dividend for purposes of section 245 of the code (relating to deduction for dividends received from certain foreign corporations).

H.R. REP. No. 1447, Technical Explanation, at A83; S. REP. No. 1881, at 227.

Section 78 requires a domestic corporation to gross-up its dividend income as a condition of the election to take the

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[45] The foreign credit is not based on the taxes paid on the entire income of the foreign subsidiary, but is rather derived from the ratio of the taxpayer's dividend income to the subsidiary's accumulated profits. I.R.C. §§902(a) and 902(c).

foreign tax credit under section 902. In contrast to other circumstances in which income must be recognized under the "tax benefit rule," such as where a bad debt previously deducted by the taxpayer is recovered, *see* I.R.C. §111, section 902 permits domestic corporation to receive a direct economic benefit for taxes it did not directly pay. The gross-up amount under section 78 is no less income for tax purposes than income attributed under the tax benefit rule. The state may rely on the federal characterization of both as gross income for tax purposes without being required to allow offsetting deductions or credits.

The imputation of income under section 78 results from the taxpayer's voluntary election to seek the benefit of the foreign tax credit. As the Appellate Court of Illinois stated, in considering Caterpillar's attempts to deduct gross-up dividend income, subpart F income, and foreign taxes from its federal taxable income:

> In making these elections, the taxpayer has, presumably, lessened its federal income tax liability. Now, the plaintiffs in this case also want to reduce their Illinois income tax liability by reversing the effect of their elections. . . .
>
> . . . As a result of their own elections, the plaintiffs have not deducted the amount of foreign taxes from and have added certain hypothetical income to their gross income, and for federal income tax purposes, they are bound by those elections. Nothing in our existing Illinois law can be found to relieve the plaintiffs of the consequences of their choices for Illinois income tax purposes.

Caterpillar Tractor Co. v. Lenckos, 77 Ill.App.3d 90, 395 N.E. 2d 1167, 1176-1177 (App.Ct. 1979), prob. juris. noted *sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, ___U.S.___, No. 81-349 (the deductibility of these items was not appealed to this Court). *See, e.g., Taxation and Revenue Department v. F. W. Woolworth*, 95 N.M. 519, 624 P.2d 28 (1981), prob. juris. noted, No. 80-1745 (J.S.A. 1a); *Commonwealth v. Westinghouse Electric Corp.*, 478 Pa. 164, 386 A.2d 491 (1978), *appeal*

dismissed, 439 U.S. 805 (1978); *Albany International v. Halperin,* 388 A.2d 902 (Me. 1978); *Commonwealth v. Rohn & Haas Co.,* 28 Pa. Commw. Ct. 430, 368 A.2d 909 (1977).

Many states rely ("piggyback") on federal taxable income in their taxing schemes. The simplicity of this system benefits both the state and the taxpayer, as Woolworth concedes. (Brief of Appellant at 29) Absent such reliance, a multistate corporation could be faced with fifty taxing schemes as complicated as the federal one; the states would be saddled with auditing and enforcement problems far beyond their individual capacities.

The federal characterization of an amount as dividends has been followed in various state cases, sometimes with advantageous consequences for taxpayers, and sometimes for state tax departments. *See, e.g., Dow Chemical Co. v. Commissioner of Revenue,* 378 Mass. 254, 391 N.E.2d 253 (1979); *Commonwealth v. Emhart Corp.,* 443 Pa. 397, 278 A.2d 916 (1970), *cert. denied,* 404 U.S. 981 (1971). The inclusion of gross-up in federal taxable income has been specifically permitted because of the economic benefit provided by the election to claim the federal tax credit. *Taxation and Revenue Department v. F.W. Woolworth; Caterpillar Tractor Co. v. Lenckos.*

The assertion that "fictional income" is being taxed as a result of state reliance on federal taxable income is not uncommon. Numerous provisions of the Code can result in the inclusion of income that taxpayers characterize as fictional, such as the requirement that a shareholder of a subchapter S corporation recognize undistributed taxable income. *See Garlin v. Murphy,* 51 Misc.2d 477, 273 N.Y.S.2d 374 (1966), *aff'd,* 34 N.Y.2d 921, 359 N.Y.S.2d 552 (1974). Although Woolworth views this and two other state cases (*Dow Chemical Co. v. Commissioner of Revenue* and *Champion International Corp. v. Bureau of Revenue,* 88 N.M. 411, 540 P.2d 1300 (Ct.App. 1975)) as merely presenting instances in which federal provisions have changed the time when income is recognized (Brief

of Appellant at 29 n. 15), this description minimizes the very real consequences of altering the time at which income is recognized. For example, a state might lose jurisdiction to impose a tax, so that the deferral of income would be permanent.

Because the federal tax code is so complex, its application results in the formulation of taxable income primarily to achieve a desired economic result. A state's reliance on federal taxable income may result in the taxation of income not yet received, but it may also result in the failure to tax income realized but not recognized.[46] The due process clause should be used to scrutinize the ultimate result of the state's reliance on federal taxable income, not the state's every inconsistency with the federal scheme.

III. THE FOREIGN COMMERCE CLAUSE DOES NOT BAR NEW MEXICO'S INCLUSION IN APPORTIONABLE BUSINESS INCOME OF DIVIDENDS RECEIVED BY BY WOOLWORTH FROM ITS FOREIGN SUBSIDIARIES.

Woolworth argues that the inclusion of its dividend, foreign exchange and gross-up income in apportionable business income will necessarily violate the foreign commerce clause unless New Mexico adjusts Woolworth's apportionment factors.

Woolworth's entire argument is premised on a purported difference between this case and *Mobil*, namely, that the taxpayer in *Mobil* conceded that its dividends were "fully taxable in the State of commercial domicile" (Brief of Appellant at 42), whereas Woolworth has not made that concession. In fact, at

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[46] *See, e.g.*, the deferral of income under section 1031 of the Internal Revenue Code (tax free exchange of like kind property).

every stage of the proceedings prior to its appearance in this Court, Woolworth has maintained that its dividend income should be allocated to its state of commercial domicile.[47] The argument that Woolworth's dividends should not be allocated to the state of commercial domicile has not been presented to any New Mexico court or administrative body. The Supreme Court's review is limited to the specific federal question that was raised in the courts below. *See Wilson v. Cook*, 327 U.S. 474, 483 (1946). Woolworth cannot now maintain that its change in position is insignificant and the Court should decline to review this point.

The foreign commerce clause question was first raised by Woolworth in its brief in the New Mexico Supreme Court. Consequently, the record does not indicate what taxes were paid on Woolworth's dividends abroad. Woolworth's theories regarding the application of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), have far ranging implications for the entire structure of state taxation and require full development prior to their consideration by this Court.

Woolworth's interpretation of the Court's decision in *Japan Line* is unjustified in view of the Court's subsequent analysis of that case in *Mobil*. Woolworth distinguishes *Mobil* because the taxpayer in *Mobil* conceded that its dividend income was "fully taxable in the State of commercial domicile" (Brief of Appellant at 42), whereas Woolworth asserts that *Japan Line* bars taxation in the absence of such a concession. In effect, Woolworth makes the novel argument that dividend income from foreign investments of a domestic corporation might not be taxable in any

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[47] In Woolworth's Memorandum Brief in the New Mexico Court of Appeals, it argued that "dividend income . . . should be separately allocated to Woolworth's state of commercial domicile." (R. 146) It maintained the same position in the New Mexico Supreme Court and in its Jurisdictional Statement in this Court. (J.S. at 7)

state.[48] The full implications of that position are significant. For Woolworth to escape the holding in *Mobil* it must show that it has "nowhere" income;[49] that is, income of an American business which is neither apportionable nor allocable to any state. If Woolworth is incorrect in this assertion, then the Court's decision in *Mobil* is directly applicable. That decision conclusively rejected the same contentions made by Mobil and disposes of Woolworth's foreign commerce clause arguments.

Woolworth's invocation of *Japan Line* and the foreign commerce clause cannot advance it beyond the argument it urges in the earlier sections of its brief. For *Japan Line* to even apply the taxpayer must show that "foreign commerce" is affected by New Mexico's taxing scheme. If New Mexico has simply taxed income attributable to Woolworth's activities within the United States, then no taxation of foreign commerce has occurred. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,*

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[48] Woolworth's claim that *no state* has the right to tax its income from dividends is a radical departure from traditional legal doctrine. In commenting on legislation which would restrict the taxation of dividend income, Professor Hellerstein stated:

> There is no legal foundation for the contention that a jurisdiction's right to tax dividends received by a payee depends on the connection of the jurisdiction to the production of the income underlying the dividend. Dividend income and operating income have traditionally been treated as distinct items of taxable income, and the power to tax the latter has never been a constitutional predicate of the power to tax the former . . . . Dividend income has traditionally been attributed to states for income tax purposes based on commercial domicile, business situs and other theories, without regard to operating income. Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076,* 79 MICH.L.REV. 113, 169 (1980) (footnote omitted).

[49] This term is used to describe income that escapes taxation by any state. Corrigan, *Interstate Corporate Income Taxation – Recent Revolutions and a Modern Response,* 29 VAND.L.REV. 423 (1976).

266 U.S. 271 (1924). *See United States Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452, 477 (1978).

Thus, the foreign commerce clause does not come into play unless New Mexico has overreached and taxed income which is attributable to foreign activities; whether New Mexico has done so is the subject of the debate over the apportionment formula. Indeed, Woolworth concedes that under the theory of apportionment, "the taxing State is not taxing any out-of-state income as such, but is simply using the out-of-state income, and the out-of-state property, payroll and sales factors, as a means of more accurately calculating the portion of the total income which is fairly attributable to activities in the taxing State." (Brief of Appellant at 45) Accordingly, the appellant argues, adjustment of the apportionment formula would avoid the foreign commerce question. (Appellant's "Questions Presented" No. 3; Brief of Appellant at 45)[50] However, the burden is on Woolworth to prove that New Mexico's statute taxes foreign income, rather than income from Woolworth's activities in the United States. Woolworth has not met that burden.[51] Therefore, the conclusion that New Mexico's taxing scheme fairly attributes to New Mexico that income which results from the taxpayer's activities in New Mexico is dispositive of the foreign commerce clause issue.[52]

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[50] While the appellant firmly maintains that "the foreign commerce clause will be violated unless a correlative adjustment is made to New Mexico's apportionment factors" (heading of Section III, Brief of Appellant at 32), it is less clear what that requested adjustment is. The appellant's argument on this point is ambivalent. It argues at an earlier point in its brief that its subsidiaries' apportionment factors must be included in the determination of its apportionable business income. (Brief of Appellant at 36, 40) Here it states that unitary apportionment of foreign source income might not be "constitutionally acceptable in practice, even if theoretically appropriate apportionment factors are used." (Brief of Appellant at 45 n. 26)

[51] *See* discussion *supra* at Section I(B) and I(C) of this brief.

[52] As the Court noted in *Mobil*, the implications of the "foreign com-

(Cont. p. 45)

Since the dividend income in question is attributable to Woolworth's activities in the United States, no restraint on state taxation arises from Woolworth's allegations of double taxation. The United States has the right to tax this income, although it has chosen to relieve domestic taxpayers of some of the burdens of double taxation. I.R.C. §901. Of course, the states are not barred from taxation because the federal government is also entitled to tax the same amount. *See Mobil*, at 448.[53]

Woolworth also argues that *Japan Line* stands for the principle that the federal policy which Woolworth discerns with regard to the taxation of dividend income is sufficient to bar state taxation of dividend income from foreign investments. *Japan Line* established a different rule for examination of state taxation of foreign commerce than that generally applicable to state taxation schemes.[54] Allegations of a general conflict between state law and national policy are usually not sufficient

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52 (Cont. from p. 44)
merce" argument cannot be limited to dividend income. 445 U.S. at 447. Any income could be alleged to have a foreign "source"; whether it is true in a particular case must be determined by the unitary business principles in Section I of this brief.

53 Professor Hellerstein rejected the double taxation argument which is made by proponents of legislation to prohibit state taxation of foreign source dividends when the foreign taxes give rise to a federal foreign tax credit: "But the federal foreign tax credit is designed to avoid duplicative taxation at the national level of earnings derived from sources outside the United States. It has – or should have – no bearing on the power of a state to tax such income. State income taxes have always been imposed in addition to federal income taxes." Hellerstein, *supra* note 48, at 1169 (footnotes omitted).

54 The primary question presented in *Japan Line* was whether California's taxing authority over property in its state was restricted by the need for a uniform federal policy in governing relations between the two nations. The Court held that the regulation of foreign commerce was "preeminently a matter of national concern," 441 U.S. at 448, so that state taxation which frustrated the "achievement of federal uniformity," 441 U.S. at 450, would be pre-empted.

to pre-empt state law: " '[p]re-emption of state law by federal statute or regulation is not favored "in the absence of persuasive reasons – either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained.' " [Citations omitted.]" *Commonwealth Edison Co. v. Montana*, 101 S.Ct. 2946, 2962 (1981). Where the argument is made that a general national policy is frustrated by a state's taxing policies, the Court finds it necessary to "look beyond general expressions of 'national policy' to specific federal statutes with which the state law is claimed in conflict." *Id.*, (footnote omitted). In contrast to *Japan Line*, this case does not involve a state's attempt to regulate foreign commerce. Therefore, any argument that federal policy pre-empts the state taxing policy requires an unmistakable indication of congressional intent to do so.

There is no specific federal statute which bars state taxation of the income of corporations with foreign investments, nor is there any other indication of a congressional policy to do so. The applicable treaties with Canada and West Germany are silent on the subject of state taxation; there is no income tax treaty with Mexico. The mere enactment of revenue laws and treaties (*see* Brief of Appellant at 46-48) providing that the United States will accord a certain treatment to dividends from foreign investments for federal income tax purposes is not sufficient to dictate that the states accord identical treatment. As the Court stated in *Mobil:* "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." 445 U.S. at 448.[55]

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[55] Woolworth maintains that this statement was made about "multiple taxation among our states." (Brief of Appellant at 49 n. 31) The quoted statement refers not to overlapping state taxation, but rather to whether states must tax all income in the same manner the federal government does, and has no relevance to taxation among the states.

Furthermore, Woolworth has cited no affirmative statement that Congress intended to restrict the treatment which the various states give to dividends paid by foreign corporations. Congress specifically withheld its consent from even less restrictive provisions of the United States–United Kingdom tax treaty which would have prohibited the states from applying the unitary apportionment method to subsidiaries and enterprises in the United Kingdom.[56] Following the Senate's rejection of these limitations on state taxing power, two bills were introduced to restrict the state's power to tax dividends from foreign corporations and from domestic corporations with substantial foreign source income.[57] Neither bill was enacted.

Finally, the federal policy regarding the taxation of dividends from investments in foreign operations is not comparable to the policy addressed in *Japan Line* regarding the taxation of containers used as instrumentalities of foreign commerce. In *Japan Line* the federal policy essentially prohibited any taxation by the nondomiciliary country.[58] Federal law here *permits* the taxation of foreign source dividends.[59] Yet, Woolworth points to the federal policy underlying the allowance of a foreign tax

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[56] 124 CONG.REC. S. 9840, 95th Cong., 2d Sess. (1978).

[57] H.R. 5076, 96th Cong., 1st Sess. (1979); S. 1688, 96th Cong., 1st Sess. (1979). Virtually identical bills were introduced in the first session of the 97th Congress: H.R. 1983, 97th Cong., 1st Sess., 127 CONG. REC. E. 619 (daily ed. Feb. 23, 1981); and S. 655, 97th Cong., 1st Sess. (1981).

[58] In *Japan Line* a customs convention barred the imposition of duties and taxes on containers temporarily imported into the United States. 441 U.S. at 453. The language of the convention has been described as sufficient in itself to bar property taxation. 19 VA. J. INT'L L. 915, 928 n. 65 (1979).

[59] A credit is provided for certain types of foreign taxes, but the United States may receive far more in taxes than does the foreign nation. For example, the appellant states that the English dividends were subject to a 5% withholding tax in the United Kingdom while the effective rate in the United States at that time was 48%.

credit, which merely reduces the effective United States tax rate, to derive a policy that would *entirely* prohibit state taxation.

Apart from these threshold barriers to the use of *Japan Line*, the case is not easily applied to the situation presented by the taxation of a domestic corporation's dividend income. In *Japan Line* California attempted to tax vessels that were owned, based and registered abroad. 441 U.S. at 436. The Court specifically objected to the "home port doctrine" because it would have the effect of barring taxation by a nondomicilary state of a domestically owned vessel, 441 U.S. at 443, and stated that it did not reach the question raised by domestically owned instrumentalities engaged in foreign commerce. 441 U.S. at 444 n. 7.[60] It cannot be assumed that the same concern for the nation's relations with foreign countries is implicated by its taxation of its own domiciliaries.

Additionally, the taxpayer in *Japan Line* demonstrated actual multiple taxation between Japan and California. 441 U.S. at 452 n. 17; *Mobil*, 445 U.S. at 448. The taxpayer cites in this Court for the first time laws of foreign countries which purportedly subjected the taxpayer's dividend income to taxation (Brief of Appellant at 43-44), and it implies that these taxes were actually paid. (Brief of Appellant at 43-44) Woolworth introduced no evidence in the record as to what specific foreign taxes it actually paid with respect to its dividend income.[61]

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[60] *See* Keesling, *The Impact of the Mobil Case on Apportionment of Income*, 1981 B.Y.U.L. REV. 87, 96 (1981) ("In any event, *Japan Line* would have no application to domestic corporations deriving income from foreign sources").

[61] The federal corporate tax return requires information concerning the payment of foreign taxes: Woolworth did not introduce this schedule (form 1118) at the hearing below and it is not part of the record. The statutory provisions cited by the taxpayer are not self-explanatory; for example, one cannot tell what the rate of the tax was nor the amount of tax actually paid in West Germany.

Ultimately, Woolworth's attempt to bring this case within the holding in *Japan Line* requires a generous attitude towards the carefully drawn language of the *Japan Line* decision. *Japan Line* addressed a very different situation from that present here: vessels used exclusively in foreign commerce, registered, based and owned in foreign countries, subject to property tax in a foreign country, and in fact taxed there, *Japan Line*, 441 U.S. at 436; a tax imposed on ownership, not income, *Mobil*, 445 U.S. at 446; the extension of tax immunity by the foreign country to vessels domiciled in the United States, *Japan Line*, 441 U.S. at 437; and, an apparent tradition of tax immunity. These distinctions suggest that compelling reasons based in constitutional analysis are required to support the application of *Japan Line* to this case. The reasons Woolworth has offered in support of its foreign commerce clause argument are legislative in nature and should be directed to a legislative forum.[62]

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[62] Woolworth does not discuss the tax treatment of exchange gain or gross-up dividend income by foreign governments, nor the policy of the United States towards foreign taxation of these amounts. Additionally, there is no evidence, for example, of where the foreign exchange transactions occurred. To the extent that Woolworth's argument does apply to these items, New Mexico's response is contained in this section.

CONCLUSION

For all the foregoing reasons, New Mexico requests this Court to affirm the decision of the New Mexico Supreme Court.

Respectfully submitted,

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APPENDIX A

NEW MEXICO STATUTES ANNOTATED, 1978

INCOME TAX GENERAL PROVISIONS

7-2-1. Short title.

This act may be cited as the "Income Tax Act."

7-2-2. Definitions.

For the purpose of the Income Tax Act, and unless the context requires otherwise:

* * *

S. "base income" means that part of the taxpayer's income generally defined as federal taxable income and upon which the federal income tax is calculated;

T. "net income" means base income adjusted to exclude:

(1) amounts that have been taxed as income to another member of an affiliated group of corporations under the Banking and Financial Corporations Tax Act [7-6-1 to 7-6-9 NMSA 1978]; and

(2) amounts that the state is prohibited from taxing because of the laws or constitution of this state or the United States; and

* * *

7-2-3. Imposition and levy of tax.

A tax is hereby imposed at the rates specified in Sections 5 and 6 upon the net income of every resident individual and every domestic corporation and upon the net income of every foreign corporation and every nonresident individual employed or engaged in the transaction of business in, into or from this state, or deriving any income from any property or employment within this state.

* * *

7-2-8. Corporate income tax rates.

The tax imposed on corporations by Section 7-2-3 NMSA 1978 shall be at the rate of five percent.

* * *

7-2-11. Income allocation.

At the election of any taxpayer, net income may be, and during the first taxable year in which an individual incurs tax liability as a resident, shall be, prior to the application of the tax rates provided in Sections 7-2-7 and 7-2-8 NMSA 1978, apportioned and allocated as follows:

* * *

B. except as provided otherwise in Subsection A of this section, income other than compensation shall be allocated and apportioned as provided in the Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 NMSA 1978];

* * *

DIVISION OF INCOME FOR TAX PURPOSES

* * *

7-4-2. Definitions.

As used in the Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 NMSA 1978]:

A. "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;

* * *

D. "nonbusiness income" means all income other than business income;

E. "sales" means all gross receipts of the taxpayer not allocated under Sections 5 through 9 [7-4-5 to 7-4-9 NMSA 1978] of the Uniform Division of Income for Tax Purposes Act; and

* * *

7-4-3. Allocation and apportionment of income in general.

Any taxpayer having income which is taxable both within and without this state, other than the rendering of purely personal services by an individual, and making the election to do so as provided in the Income Tax Act [7-2-1 to 7-2-22 NMSA 1978], shall allocate and apportion his net income as provided in the Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 NMSA 1978].

7-4-4. When taxable in another state.

For purposes of allocation and apportionment of income under the Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 NMSA 1978], a taxpayer is taxable in another state if:

A. in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

B. that state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether the state does or does not.

7-4-5. Allocation of certain nonbusiness income.

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 6 through 9 [7-4-6 to 7-4-9 NMSA 1978] of the Uniform Division of Income for Tax Purposes Act.

7-4-6. Allocation of rents and royalties.

A. Net rents and royalties from real property located in this state are allocable to this state.

B. Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state; or

(2) in their entirety if the taxpayer's commercial domicile

is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

C. The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

7-4-7. Allocation of capital gains and losses.

A. Capital gains and losses from sales of real property located in this state are allocable to this state.

B. Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) the property had a situs in this state at the time of the sale; or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

C. Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

7-4-8. Allocation of interest and dividends.

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

7-4-9. Allocation of patent and copyright royalties.

A. Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state; or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

B. A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

C. A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

7-4-10. Apportionment of business income.

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

7-4-11. Property factor for apportionment of business income.

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

7-4-12. Valuation of property for inclusion in property factor.

Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rate is the annual rental paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

7-4-13. Determination of average value of property for inclusion in property factor.

The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the commissioner of revenue [director of the revenue division of the taxation and revenue department] may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

7-4-14. Payroll factor for apportionment of business income.

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

7-4-15. Determination of compensation for inclusion in payroll factor.

Compensation is paid in this state if:

A. the individual's service is performed entirely within the state; or

B. the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

C. some of the service is performed in the state and:

(1) the base of operations, or, if there is no base of operations, the place from which the service is directed or controlled is in the state; or

(2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

7-4-16. Sales factor for apportionment of business income.

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

7-4-17. Determination of sales in this state of tangible personal property for inclusion in sales factor.

Sales of tangible personal property are in this state if:

A. the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

B. the property is shipped from an office, store, warehouse, factory or other place of storage in this state and:

(1) the purchaser is the United States government; or

(2) the taxpayer is not taxable in the state of the purchaser.

7-4-18. Determination of sales in this state of other than tangible personal property for inclusion in sales factor.

Sales, other than sales of tangible personal property, are in this state if:

A. the income-producing activity is performed in this state; or

B. the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

7-4-19. Equitable adjustment of standard allocation or apportionment.

If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 NMSA 1978] do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the director of the revenue division of the taxation and revenue department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

A. separate accounting;

B. the exclusion of any one or more of the factors;

C. the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

D. the employment of any other method to effectuate an

equitable allocation and apportionment of the taxpayer's income.

7-4-20. Agreements authorized in unusual cases.

In circumstances within the scope of Section 19 [7-4-19 NMSA 1978] of the Uniform Division of Income for Tax Purposes Act and in other circumstances where the revenues of the state would not be adversely affected, the commissioner [director of the revenue division of the taxation and revenue department] is authorized to enter into an agreement in writing with any person with respect to apportionment and allocation of his income. Except upon a showing of fraud or misrepresentation of a material fact, or a change in the statutory law, such agreement shall be conclusive. Any agreement, however, may be terminated by either party by written notice thereof to the other party at least 90 days before the beginning of the taxable year to which the termination shall apply.

7-4-21. Construction of act.

The Uniform Division of Income for Tax Purposes Act [7-4-1 to 7-4-21 NMSA 1978] shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.

MULTISTATE TAX COMPACT

* * *

7-5-2. Election of alternative tax.

Any person:

A. who is required by the Income Tax Act to file a return; and

B. whose only activities in New Mexico consist of making sales; and

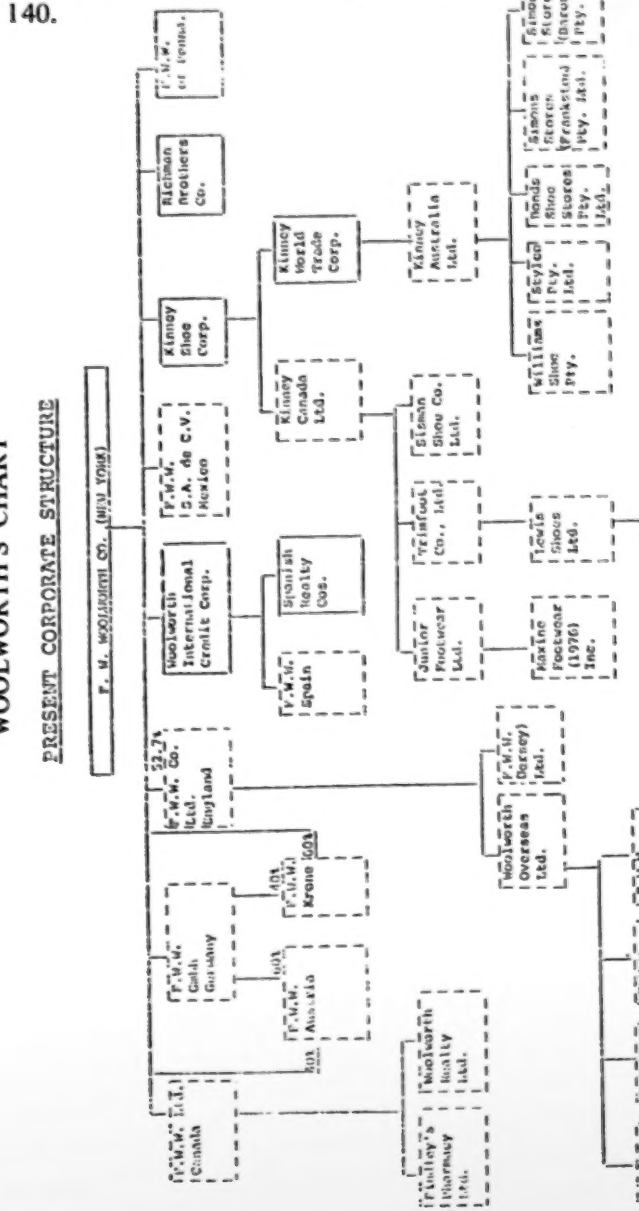
C. who does not own or rent real estate within the state of New Mexico; and

D. whose annual gross sales in or into New Mexico amount to not more than one hundred thousand dollars ($100,000), may elect to pay a tax of three-fourths of one percent of his annual gross receipts derived from sales in or into New Mexico in lieu of paying an income tax.

* * *

APPENDIX B

Submitted as Taxpayer's Exhibit A—Record, p. 140.



CERTIFICATE OF SERVICE

I hereby certify that on the 15th day of January, 1982, I, Sarah E. Bennett, a member of the bar of the Supreme Court, caused to be mailed, postage prepaid, three copies of the foregoing Brief of Appellee to George W. Beatty and William L. Goldman, Counsel for the Appellant, at 1200 - 18th Street, N.W., Washington, D.C. 20036 and to Michael D. Bray, at 919 Third Avenue, New York, New York 10022. I further certify that all parties required to be served have been served.

SARAH E. BENNETT
Special Assistant Attorney General

Supreme Court, U.S.
FILED
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CLERK

No. 80-1745

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO., *Appellant,*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

REPLY BRIEF OF APPELLANT

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TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

Appeal from the Supreme Court of New Mexico

REPLY BRIEF OF APPELLANT[1]

This brief responds to certain arguments advanced by the Taxation and Revenue Department of the State of New Mexico ("New Mexico") in its brief and by the Multistate Tax Commission ("MTC") in its *amicus* brief.

I. THE INCLUSION OF THE DIVIDENDS, EXCHANGE GAIN, AND GROSS-UP IN APPORTIONABLE BUSINESS INCOME CONTRAVENES THE DUE PROCESS CLAUSE.

It is now clear from New Mexico's brief that the State seeks a result that is in conflict with this Court's holding in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980) (hereinafter

[1] As required by Rule 28.1 of the Rules of this Court, a list of appellant's subsidiaries (other than wholly owned subsidiaries) and affiliates is set forth on page (i) of the Brief of Appellant.

"Mobil"). In *Mobil*, this Court upheld the inclusion of dividends in apportionable business income only after first determining that Mobil's business activities and those of the payor corporations were sufficiently integrated so as to constitute parts of the same unitary business. Thus, as this Court noted (445 U.S. at 441), had Mobil—

> . . . chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives. [Footnote deleted.]

New Mexico expressly acknowledges that *Mobil* involved a situation where a single unitary business was conducted in a multicorporate form (*i.e.*, by both the recipient and the dividend-paying corporations) so that the dividends were paid out of the earnings of the unitary business. (N.M. Br. 22-23) New Mexico also acknowledges that this is not the case here, stating (N.M. Br. 15):

> The parties have no disagreement as to the boundaries of Woolworth's unitary business. Both the taxpayer and New Mexico describe Woolworth as operating a unitary business in the fifty states, Puerto Rico and the Virgin Islands.

This statement constitutes clear recognition by New Mexico that appellant did not conduct a unitary retail

business with any of its foreign, dividend-paying subsidiaries. New Mexico has even stated in so many words that it would not have included the income of those subsidiaries in apportionable business income if their operations had been conducted directly by appellant in divisions. (N.M. Br. 29, n.32)

Thus, New Mexico has finally recognized that the record in this case (see appellant's brief, pp. 19-25) compels the conclusion that appellant was *not* conducting a single, unitary business with its foreign subsidiaries.[2] By so agreeing, New Mexico has effectively repudiated the grounds on which the New Mexico Supreme Court based its decision. That court upheld the apportionability of the dividends in issue only after first concluding, as it was requested to do by New Mexico, that the "functional integration" test of *Mobil* was satisfied.[3] In this regard, the New Mexico Supreme Court stated (J.S. App. A 19a):

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[2] New Mexico's concession based on the record in this case involving the fiscal year 1977 is in no way diminished by a recent California Superior Court Memorandum concluding that appellant and its Canadian subsidiary were engaged in a unitary business during the period 1961-1964. See *F. W. Woolworth Co.* v. *Franchise Tax Board of the State of California* (Cal. Sup. Ct. Dept. No. 19, Docket No. 656 793), Notice of Intended Decision dated Feb. 3, 1982.

[3] New Mexico filed a supplemental brief in the New Mexico Supreme Court, following this Court's decision in *Mobil*, in which New Mexico stated (p. 3):

> Throughout this appeal, the Department has argued that it is not necessary for the taxpayer and its foreign subsidiaries to be a unitary business, in order to call the dividend income 'business income.' The Supreme Court, however, seems to find it necessary that the businesses be unitary, if the income from one to the other is to be apportioned by a state. That portion of the *Mobil* opinion has little impact on this case, because the Hearing Officer found Woolworth to be unitary with its foreign subsidiaries and Woolworth has not shown otherwise.

> On the due process issue and in conformity with *Mobil,* we hold that, for income tax considerations, there is substantial evidence in this record that Woolworth was conducting a unitary business with its foreign subsidiaries and that there is a sufficient nexus between the corporation and the State of New Mexico to justify an apportioned tax on these dividends. The income is obviously related to the mutual activities of the parent and its affiliates. The control over the subsidiaries, the interdependence, the history of the relationships, the placing of the money in the general operating account, all point to functional integration and reveal an underlying unitary business for our purposes here.

By now conceding that appellant did *not* conduct a unitary business with its foreign subsidiaries, New Mexico has effectively conceded its case.

New Mexico is now left with an untenable position that unavoidably contradicts this Court's reasoning in *Mobil.* Although the whole teaching of Mobil is that the taxpayer's corporate structure (445 U.S. at 441) "ought not to affect the apportionability of income the parent receives," New Mexico seeks just the opposite result here. In *Mobil,* this Court held that apportionability should not change simply because the taxpayer chooses to conduct certain business activities in separate subsidiaries. By contrast, New Mexico seeks to include the dividends in issue in apportionable income *solely* because appellant has chosen to conduct certain foreign activities in separate subsidiaries. New Mexico's entire case turns on differences in corporate structure and the perception of the income in issue as "income from intangibles"—as contrasted with operating

income.[4] Such an approach cannot be reconciled with this Court's approach in *Mobil*.

Quite surprisingly, New Mexico cites *Mobil* for the proposition that dividends should be treated like other income. (N.M. Br. 23) We agree. It is New Mexico which applies the double standard. This is fully demonstrated by New Mexico's reasons (N.M. Br. 16-17) for treating the dividends as apportionable business income. For example, New Mexico relies on the large number of Woolworth stores worldwide, consolidated financial statements, placing dividends in the general treasury, and other similar factors. Those factors were dealt with in appellant's brief (pp. 19-25) as part of our demonstration that appellant did not conduct a unitary business with its foreign subsidiaries. Given that showing (with which New Mexico agrees), why should those factors be sufficient to justify the apportionment of dividends when (as New Mexico admits) those factors would not be sufficient to justify apportionment if the foreign subsidiaries were operated as divisions of Woolworth? Why should those factors be any more pertinent to the business relationship between appellant's domestic Unitary Business and the ownership of stock in foreign subsidiaries than those factors would be to the business relationship between appellant's domestic Unitary Business and the

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[4] New Mexico has stated (N.M. Br. 29) that it would not tax the income of the foreign retail operations if those operations were conducted directly as divisions of appellant. Yet New Mexico seeks to tax dividends paid out of that income as a consequence of conducting the foreign retail operations in subsidiaries. The only difference between the two situations involves appellant's choice of corporate structure.

direct conduct of foreign operations in divisions? Why should a State be allowed to expand its taxing authority solely because stock ownership is involved?

Appellant, on the other hand, seeks to apply *Mobil* consistently by treating dividends like other income. Under *Mobil*, 445 U.S. at 439, the "linchpin of apportionability in the field of state income taxation is the unitary-business principle." In the case of dividends from substantial operating subsidiaries, this means that apportionability is permissible only where the activities of the recipient and payor corporations are parts of a single, functionally integrated business.

Nonetheless, New Mexico asserts (N.M. Br. 23) that dividends are apportionable as business income so long as "the taxpayer's investment in the dividend paying corporations contributes to and enhances the value of the taxpayer's business" even though "such corporations are not a unitary part of the taxpayer's business." Similarly, the MTC asserts that dividends may be apportioned as long as the stock investment is "rationally related" to the taxpayer's unitary business. (MTC Br. 8-9, 16-17) These tests are too broad. They are also inconsistent with the rationale for apportionability (see pages 14-17 of our main brief) and unsupported by the cases cited by New Mexico (N.M. Br. 16-19).[5]

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[5] For example, in *W. R. Grace & Co.* v. *Commissioner of Rev.*, 378 Mass. 577, 393 N.E.2d 330 (1979), involving the gain from Grace's sale of its stock in the Miller Brewing Company, the court noted (393 N.E.2d at 335): "[t]he record and the findings of the board indicate the Miller holding was acquired by Grace in order to bolster and expand its unitary operations." Grace also acknowledged (*ibid.*) "that all its operating businesses in the United States, including its Massachusetts activities, are unitary for the purposes

In our main brief, we noted (pp. 18-19) that there may be situations not discussed in *Mobil*, and not present here, in which a stock investment is sufficiently related to a taxpayer's unitary business to justify apportionment of the dividends even though the taxpayer is not conducting a unitary business with the dividend-paying corporation. We referred, for example, to dividends received by a securities dealer on stocks held in inventory for sale to customers. Another example would be income from short-term investments of working capital used in the unitary business. See, *e.g.*, *Sperry & Hutchinson Co.* v. *Dept. of Rev.*, 270 Ore. 329, 527 P.2d 729 (1974). However, these exceptions to the "functional integration" test of *Mobil* have no applicability in cases such as this or *Mobil*, involving investments in large, operating subsidiaries. New Mexico's case essentially amounts to nothing more than an

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of State taxation." Under these circumstances it is reasonable to infer that Massachusetts would have treated Grace's portion of the Miller operations as part of Grace's unitary business if Miller had been liquidated and operated as a joint venture. Similarly, in the other cases cited by New Mexico involving other types of income from intangibles, the courts have been careful to analyze the functional relationship between the intangibles involved and the unitary business. In *Sperry & Hutchinson Co.* v. *Dept. of Rev.*, 270 Ore. 329, 527 P.2d 729 (1974), for example, the court held that certain short-term securities were held in connection with the taxpayer's business and that other short-term securities and long-term securities were not held in connection with the taxpayer's business. See also *Qualls* v. *Montgomery Ward & Co., Inc.*, 266 Ark. 207, 585 S.W.2d 18 (1979); *Xerox Corp.* v. *Comptroller of Treasury*, 290 Md. 126, 428 A.2d 1208 (1981). Appellant does not necessarily concede the correctness of these decisions. But they cannot properly be cited, as New Mexico seeks to do, as support for a more relaxed unitary business test where business operations are conducted in separately incorporated subsidiaries.

assertion that dividends from large subsidiaries are always apportionable because it is advantageous or profitable to own large subsidiaries. Such a broad proposition cannot be reconciled with this Court's opinion in *Mobil*.[6] Thus, even if this Court should hold that functional integration is not necessary in every case, more must be required than is present here for dividends to be includible in apportionable income.

This does not mean, as New Mexico asserts, that we have disregarded the distinction between a parent corporation and its subsidiary. For example, New Mexico states (N.M. Br. 11) that "[t]he substance of Woolworth's contention is that dividend income may be taxed by a state only if that state has jurisdiction to tax the payor of the dividends." That is not so. We recognize that the dividends in issue are part of appellant's income which may, for due process purposes, be taxed by the State of commercial or legal domicile. However, as this Court explained in *Mobil* (445 U.S. at 439), it is necessary to evaluate the relationship between appellant's foreign subsidiaries and its domestic Unitary Business in order to determine whether the dividend income is part of the apportionable income of that Business (and therefore also subject to tax in every State in which the Business is conducted) or is income of a "discrete business enterprise" (and therefore not subject to apportionment). See also *Mobil*, 445 U.S. at 445-446. And for this purpose, it is essential, as was done in *Mobil*, to examine the relationship between appellant's domestic Unitary

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[6] "We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where the corporation does business." *Mobil*, 445 U.S. at 441-442.

Business and the underlying activities of the payor corporations. In this case, appellant's domestic Unitary Business and the operations of its foreign subsidiaries are "discrete business enterprises."

II. ALTERNATIVELY, THE DUE PROCESS CLAUSE AND THE COMMERCE CLAUSE REQUIRE A CORRELATIVE ADJUSTMENT TO THE NEW MEXICO APPORTIONMENT FACTORS IF SOME PORTION OF THE DIVIDENDS, EXCHANGE GAIN, AND GROSS-UP MAY BE INCLUDED IN APPORTIONABLE BUSINESS INCOME.

A. The Due Process Clause

As discussed above, the basic holding of *Mobil* is that the apportionability of a resident corporation's income to a nondomiciliary State should not be affected by the corporation's choice of corporate structure for conducting its various operations. We pointed out in our main brief that the value of appellant's activities in New Mexico (and the portion of appellant's income properly subject to tax in New Mexico) should not be affected one way or the other by appellant's decision to own foreign businesses as subsidiaries rather than as divisions. We also demonstrated, however, (pp. 33-35) that the amount of appellant's New Mexico taxable income would be disproportionately increased (as a consequence of owning foreign subsidiaries instead of divisions) if the inclusion of the disputed items in apportionable income were not accompanied by a correlative adjustment to the New Mexico apportionment factors.

New Mexico apparently agrees that the amount of appellant's income properly apportioned to New Mexico should not differ depending on the choice of corporate structure. Nor could New Mexico contend otherwise since the value of the intrastate activities in

New Mexico is not affected by the choice of corporate structure. Nevertheless, New Mexico states (N.M. Br. 29):

> Woolworth contends that New Mexico's apportionment statute violates due process because it attributes differing amounts of income to New Mexico, depending merely on the corporate structure of the taxpayer. (Brief of Appellant at 33) The facts do not support this contention.

The fact is, as discussed above, that New Mexico's entire case *is* based on appellant's choice of corporate structure, under which appellant's foreign operations were placed in dividend-paying subsidiaries. New Mexico admits that it could not otherwise have taxed directly the income of those foreign operations; yet it claims to be able to tax dividends paid out of those earnings. Absent correlative factor modification, this approach presents the clearest possible case in which the amount of income apportioned to New Mexico would vary depending on the choice of corporate structure. The result is the same as in the example discussed at pages 33-35 of our main brief, and neither New Mexico nor the MTC has refuted that example.[7]

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[7] The MTC brief (MTC Br. 22) refers to examples on pages 18-22 of its *amicus curiae* brief in *ASARCO Incorporated (formerly the American Smelting and Refining Company)* v. *Idaho State Tax Commission, prob. juris. noted,* —— U.S. ——, No. 80-2015. Those examples are not helpful, since they contain errors and relate to factual situations not present here. For example, the combined reporting calculation on the top of page 20 of the MTC brief in *ASARCO* is erroneous because it includes Corporation B's property, payroll, and sales in the denominators, but not in the numerators, of the apportionment fractions. In any event, the basic issue, which the MTC examples fail to address, is whether the apportionability of income should depend on the choice of corporate structure. New Mexico's position inevitably leads to that result.

In *Mobil*, this Court was confronted with a situation where a single unitary business transcended corporate boundaries and included the activities of the dividend-paying subsidiaries. Here, New Mexico now presses an entirely different ground for including the dividends in apportionable business income—*i.e.*, that the stock of the foreign subsidiaries is an asset of appellant's separate Unitary Business. Apparently, New Mexico believes that because the dividends from this stock are the separate income of appellant, the apportionment fraction can be based solely on appellant's separate payroll, property, and sales. Both New Mexico and the MTC contend that all of appellant's income, including dividends from functionally separate subsidiaries, can properly be apportioned on the basis of a formula which only takes into account factors that relate to appellant's operating income (*i.e.*, appellant's own tangible property, payroll, and sales). See N.M. Br. 31-32; MTC Br. 8-16.

Appellant disagrees. New Mexico's view of the case as involving income from intangibles still would not diminish or alter the need for an adjustment to the New Mexico apportionment factors. Those factors, as presently applied, still fail to account adequately for appellant's substantial investment in major foreign subsidiaries operating totally outside New Mexico. It is true that appellant's out-of-state payroll factor reflects its direct salary costs associated with the oversight of the foreign subsidiaries. But this amount is negligible.[8] The token adjustment that New Mexico

[8] New Mexico chides appellant (N.M. Br. 8-9, 17) for having deducted the payroll expenses associated with oversight of its foreign subsidiaries in arriving at apportionable business income. Conceptually, New Mexico may be correct and appellant would agree to an

has made to the sales factor is also wholly inadequate because the denominator of the sales factor reflects only the dividends, exchange gain, and gross-up in dispute, and *not* the sales of the foreign subsidiaries.[9] Finally, New Mexico has made no adjustment at all to the property factor. Appellant's investments in its large foreign subsidiaries operating entirely outside New Mexico accounted for approximately 76% of appellant's total apportionable income as computed by New Mexico (*viz.*, $66,979,494 out of $87,603,703). (J.A. 57a, 69a) Under these circumstances, a further meaningful adjustment to the apportionment formula is constitutionally required to reflect the out-of-state property, payroll, and sales which produced that income.[10] See the authorities

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appropriate adjustment in this regard on remand. The practical answer, however, is that these expenses were *de minimis*. Cf. *F. W. Woolworth Co.* v. *Commissioner*, 54 T.C. 1233, 1267-1270 (1970) in which the Tax Court held that no expenses of this type need be allocated to Woolworth's foreign source dividend income for federal tax purposes. In any event, appellant's failure to separately account for these minor expenses here affords New Mexico no basis for including almost $67 million of dividends, exchange gain, and gross-up in apportionable income.

[9] The dividends, exchange gain, and gross-up aggregate $66,979,494, whereas appellant's other gross receipts aggregate $2,507,990,364. (J.A. 57a, 69a) Including the disputed items in the denominator of the sales factor only reduced that factor from .528448 of 1%, as reported, to .514233 of 1%. (J.A. 57a, 69a) Equating dividends with gross receipts is indefensible; $1 of dividends (representing *net* profits) should be accorded more weight than $1 of gross receipts (which represents only a few cents of net profits).

[10] Although New Mexico increased appellant's apportionable income from $20,624,209 (the amount originally reported plus an undisputed interest adjustment) to $87,603,703, the apportionment factor was only reduced from .463073 of 1% to .458335 of 1%—hardly an adequate adjustment. (J.A. 57a, 69a)

cited on page 39 of our main brief. The cases cited by New Mexico and the MTC involving intangibles in other contexts simply are not responsive to this problem.[11]

New Mexico also claims repeatedly that appellant has failed to carry its burden of showing that New Mexico's apportionment formula "results in extra-territorial values being taxed." *Butler Bros.* v. *McColgan*, 315 U.S. 501, 507 (1942). For example, New Mexico suggests that $401,518 (the amount of income arrived at under its formula) is not too much to attribute to appellant's retail operations in New Mexico. After increasing apportionable income from $20,624,209 (appellant's agreed operating income) to $87,603,703 (by adding foreign dividends, exchange

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[11] In *Adams Express Co.* v. *Ohio State Auditor*, 165 U.S. 194, *reh'g denied*, 166 U.S. 185 (1897), involving a property tax, the value of the property in Ohio was determined by taking a percentage of the value of the corporation's outstanding capital stock. The intangible assets thus apportioned were the corporation's goodwill and franchises as reflected in the value of the corporation's stock. But these assets are clearly integrated with the underlying business of the corporation and afford no parallel to the issue here—namely, the apportionment of income from investments in separate foreign subsidiaries. This also applies to *Ford Motor Co.* v. *Beauchamp*, 308 U.S. 331 (1939). *Flint* v. *Stone Tracy Co.*, 220 U.S. 107 (1911), involved the imposition of a federal excise tax on corporations and did not address the apportionment issue presented here.

Some of the cited cases involved the situs of intangibles for purposes of property or corporate excise on franchise taxes. To the extent they deal with stock, they hold that the situs is the State of the corporate-stockholder's business headquarters (*First Bank Corp.* v. *Minnesota*, 301 U.S. 234 (1937)) or the domicile of an individual (*First Nat. Bank* v. *Maine*, 284 U.S. 312 (1932). See also *National Leather Co.* v. *Massachusetts*, 277 U.S. 413 (1928).

gain, and gross-up), New Mexico even claims that the resulting attribution of $401,518 to New Mexico may "very well" be the amount of income produced by appellant's local New Mexico activities. (N.M. Br. 28) If so, it would be a remarkable coincidence and irrelevant to the issue presented here.

Appellant submits, as shown by the foregoing discussion, that it has carried its burden. It is not necessary to show that the precise dollar amount arrived at under New Mexico's formula was wrong. *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell,* 283 U.S. 123, 136-137 (1931). The issue here is one of methodology—namely, the extent to which New Mexico may constitutionally tax large foreign-source investment income which, as such, did not arise from appellant's local activities in New Mexico. Notice that New Mexico nowhere asserts that appellant's "acquisition, management, and disposition" of its foreign subsidiaries (*i.e.,* the activities which assertedly gave rise to this business income) constituted New Mexico activities; indeed, it concedes just the opposite by (1) describing appellant's New Mexico activities as being limited to the operation of a store, and (2) allocating all of the disputed income items to the denominator (but not the numerator) of the sales factor.

Accordingly, unless the New Mexico apportionment factor is modified, New Mexico's apportionment method will be "inherently arbitrary, or a mere effort to reach profits earned elsewhere under the guise of legitimate taxation." *Bass, Ratcliff & Gretton* v. *State Tax Commission,* 266 U.S. 271, 283 (1924). The dis-

puted income from investments is "in no just sense attributable to transactions within" New Mexico. *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell, supra,* 283 U.S. at 134. Consequently, absent factor modification, New Mexico's apportionment method is unconstitutional.

B. The Commerce Clause

Most of New Mexico's Commerce Clause arguments have been dealt with in our main brief. There are several points, however, that warrant a further response here.

First, New Mexico questions whether our Foreign Commerce Clause argument was adequately raised below. In particular, New Mexico states (N.M. Br. 42):

> The argument that Woolworth's dividends should not be allocated to the state of commercial domicile has not been presented to any New Mexico court or administrative body. The Supreme Court's review is limited to the specific federal question that was raised in the courts below. *See Wilson* v. *Cook,* 327 U.S. 474, 483 (1946). Woolworth cannot now maintain that its change in position is insignificant and the Court should decline to review this point.

As is set forth in detail in our main brief, our Foreign Commerce Clause argument is based on New Mexico's failure to adjust the apportionment factors, thereby permitting New Mexico to impose a direct tax on foreign-source investment income that has already been taxed abroad. Furthermore, since the laws and treaties of this Nation explicitly provide (in accord-

ance with international custom) for the avoidance of such double taxation at the federal level, New Mexico's failure to use some mechanism that will avoid international double taxation at the state level prevents this Nation from speaking with one voice in matters that affect this Nation. Appellant's brief in the New Mexico Supreme Court contains precisely the same argument as follows (pp. 29-30):

> . . . failure to provide a foreign tax credit or eliminate the double tax effect will result in the *international double taxation* that violates the Foreign Commerce Clause. *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434 (1979). (Emphasis supplied.)

Our assertion that the foreign-source investment income may not be taxed by either a State of commercial domicile or a nondomiciliary State is merely a refinement of this basic Foreign Commerce Clause argument, and is properly presented here. Cf. *Commissioner* v. *Gordon,* 391 U.S. 83, 95, n.8 (1968). For, as this Court pointed out in *Mobil,* 445 U.S. at 447, if the State of commercial domicile may tax the income, then the issue is not one of international double taxation but of duplicative state taxation, a problem that can be avoided through proper apportionment. In view of this portion of the Court's decision in *Mobil,* which was announced following the submission of appellant's brief to the New Mexico Supreme Court,[12] it is appropriate for appellant to clarify its position in this Court as to the right of the State of

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[12] *Mobil* was decided on March 19, 1980. Appellant's brief in the New Mexico Supreme Court was filed on March 11, 1980. (J.A. 3a)

commercial domicile to tax the dividends in issue.[13] Finally, the same legal question is before the Court in *ASARCO Incorporated (formerly the American Smelting and Refining Company)* v. *Idaho State Tax Commission, prob. juris. noted,* —— U.S. ——, No. 80-2015. Under these circumstances, appellant's Commerce Clause argument is properly before the Court.

New Mexico also contends (N.M. Br. 42) that "the record does not indicate what taxes were paid on Woolworth's dividends abroad." As we showed in our main brief (pp. 43-44), Australia, Germany, Mexico, and the United Kingdom all imposed an income withholding tax on the full amount of dividends in issue. Technically, as this Court has held, a state tax violates the Commerce Clause if it merely "creates a substantial *risk* of international multiple taxation." *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434, 451 (1979) (emphasis supplied). In this case, it is undisputed that appellant was subject to tax on its dividend income in all four foreign countries involved, with the result that appellant's foreign-source dividends would clearly be subject to multiple international taxation if New Mexico's position were upheld. Accordingly, under these circumstances, it is unnecessary to demonstrate that the foreign tax liabilities were, in fact, paid.

The key issue here is whether, as appellant claims, New Mexico has taxed directly, by its failure to adjust its apportionment factors, a portion of appellant's

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[13] This Court also has held that when a new argument is made in response to an intervening court decision, the argument may be considered. *Hormel* v. *Helvering,* 312 U.S. 552, 557-559 (1941). The refinement of our general Foreign Commerce Clause argument in this case does not even go that far.

foreign-source investment income which was earned outside New Mexico. If appellant's view is correct, then New Mexico's inclusion of the disputed items in income without an adequate adjustment to the apportionment factors inevitably results in multiple foreign and state taxation. New Mexico inferentially recognizes that the Foreign Commerce Clause is applicable if "New Mexico has overreached and taxed income which is attributable to foreign activities." (N.M. Br. 44) But New Mexico asserts (N.M. Br. 45) that "the dividend income in question is attributable to Woolworth's activities in the United States."

There simply is no support for New Mexico's view. The dividends are "foreign-source," earned by investments made outside of New Mexico in foreign subsidiaries operating outside New Mexico. The income cannot be said to be directly attributable to any activities in New Mexico.[14] New Mexico cites Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076,* 79 Mich. L.Rev. 113, 166 (1980), as support for its position. In fact, Professor Hellerstein's article directly supports our position here. Professor Hellerstein does say (pp. 168-169) that a State may include foreign-source dividends in taxable income, *but only where the inclusion of such dividends is accompanied by an appropriate adjustment to the apportionment factors.* Similarly, in his discussion of this Court's decision in *Mobil,* Professor Hellerstein states (pp. 127-128):

> But the Court's remarks were directed to cases in which the factors—real and tangible personal

[14] See also pp. 14-15, *supra.*

> property, payroll and sales—were rationally related to the operating income of the taxable corporation. By contrast, Vermont was applying its formula to income that, in form at least, derived from Mobil's investments in its subsidiaries and affiliates, not from its operations. When a corporation receives between 80 and 120% of its taxable income from intangible property, it is anomalous—and perhaps grossly distorting—to apportion such income by a formula that, among other things, takes no account of intangible property. (Footnotes omitted.)

Professor Hellerstein's article rejects the result which New Mexico seeks to defend here. There is no support for the inclusion of such substantial foreign-source dividends in the apportionable income base without a correlative adjustment to the apportionment factors.

Finally, as to New Mexico's argument concerning the applicability of *Japan Line, Ltd.* v. *County of Los Angeles, supra,* to income tax cases, we note that our position in that regard is fully supported by the *Amicus Curiae* Memorandum of the United States in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., prob. juris. noted,* —— U.S. ——, No. 81-349. Furthermore, the United States also supports our view that the decision in *Mobil* did not consider our Foreign Commerce Clause argument in view of the concession in *Mobil* that the dividends there in issue could be taxed by the State of commercial domicile. See the footnote on page 16 of the United States' Memorandum.

CONCLUSION

For the foregoing reasons and for the reasons stated in appellant's main brief, this Court should reverse the decision below and remand the case to the Supreme Court of New Mexico for further proceedings.

Respectfully submitted,

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No. 80-1745

In the Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO.,
Appellant,

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,
Appellee.

On Appeal from the Supreme Court of New Mexico

BRIEF OF AMICUS CURIAE STATE OF ILLINOIS IN SUPPORT OF APPELLEE

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TAXATION AND REVENUE DEPARTMENT OF
THE STATE OF NEW MEXICO,
Appellee.

BRIEF OF AMICUS CURIAE STATE OF ILLINOIS IN SUPPORT OF APPELLEE

STATEMENT OF INTEREST

The decision in this case will affect the tax revenues and the burden of taxation in Illinois and every other state which imposes an income tax. Also, it will affect the development toward full and fair apportionment of income among the States. See Corrigan, *Toward Uniformity in Interstate Taxation*, Tax Notes, pp. 507-14 (September 15, 1980). Illinois is not a member of the Multistate Tax Commission, but it has adopted substantially all of the Uniform Division of Income

for Tax Purposes Act (UDITPA) apportionment provisions. Ill. Rev. Stat. (1981) Ch. 120, Article 3. As such, Illinois is concerned that this Court be informed about two essential elements of UDITPA — business income and combined apportionment — and that these two elements withstand constitutional scrutiny.

THE DEFINITION OF "BUSINESS INCOME" GUARANTEES CONFORMITY WITH THE DUE PROCESS CLAUSE

A. *MOBIL* Does Not Prevent A State From Apportioning Income Earned On Stock Investments If It Constitutes "Business Income"

Appellant wants to avoid state taxation on "foreign source" income generated by its investment in certain corporations. It contends that unless two corporations are functionally integrated, all dividend income received by the payee should be attributed to the business activities of the payor.

This ignores the well-established state and federal tax principle that a dividend is taxed as income to the payee, and it is different from profits which are taxed as income to the payor. *In re Goodyear Tire and Rubber Co.*, 133 Vt. 132, 335 A. 2d 310 (1975).

Appellant's argument is also totally at odds with this Court's decisions in cases involving intangible property or the income derived therefrom and apportioned state taxes. *Adams Express Co. v. Ohio State Auditor*, 164 U.S. 194 (1897) rehearing denied 166 U.S. 185; *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939); *Mobil Oil Corp. v. Com'r. of Taxes of Vermont*, 445 U.S. 425 (1980). These cases hold that intangibles or income from intangibles may be appor-

tioned among the jurisdictions in which the taxpayer conducts unitary business activities. See *Curry v. McCanless*, 307 U.S. 357, 367 (1939).

Appellant principally relies on *Mobil Oil, supra*, but it is clear that this reliance is misplaced, and, in accord with prior decisions of this Court, *Mobil* supports the tax imposed by appellee. *Mobil* decided that there is nothing about the character of income earned from investments in corporations operating abroad that precludes state taxation by the apportionment method. Simply because income is received in the form of dividends or because it is received from a "foreign source" does not mean that it can escape an apportioned state income tax. In order to avoid taxation on investment income, a taxpayer must demonstrate that there is no "minimal connection". It must show that the income " . . . was earned in the course of activities unrelated to the [conduct of activities in the taxing State.]", 100 S. Ct. at 1232; that " . . . the business activities of the dividend payor have nothing to do with activities of the recipient in the taxing State,", 100 S. Ct. at 1233-4; or that there was " . . . unrelated business activity on the part of its subsidiaries and affiliates . . . ", 100 S. Ct. at 1234. A taxpayer cannot make this showing where the income in question is "business income". *Infra*, P. 5

Appellant's argument is not framed in terms of "unrelated business activities". It is framed in terms of "functionally integrated" corporations and it confuses the factual findings in *Mobil* with the legal principles enunciated therein. This Court found that *Mobil* together with its subsidiaries and affiliates engaged in or contributed to an integrated petroleum enterprise. 100 S. Ct. at 1230. This finding provided a relationship of business activities which satisfied the Due Process Clause. (The record in this case shows that appellant also operated an integrated enterprise.) However, the integrated enterprise found to exist in *Mobil* was not referred to as the

only situation in which the constitutional standard could be met. The language quoted above makes it clear that a state can apportion dividends if they constitute "business income" as defined in UDITPA.

In addition, one should keep in mind the difference in the statutes involved. Vermont apportions federal taxable income, with minor modifications, so the unitary business principle is a useful context in which to view the Vermont statute and the income earned from Mobil's business activities.[1] UDITPA, on the other hand, determines the contours of a unitary business,[2] it distinguishes between business and nonbusiness income, and then it apportions only business income. *Mobil* did not consider whether the relationship of income to business activity, required under UDITPA's definition of business income, conforms to the requirements of the Due Process Clause. Thus, appellant's contention that *Mobil* prohibits the apportionment of dividends unless the corporations are functionally integrated is unjustified.

All of the States which impose an income tax (or a privilege or franchise tax measured by net income) have chosen to apportion income earned from business activities conducted within and without a State rather than to separately account for income earned within a State. Although appellant seems to recognize the shortcomings of separate accounting, it nonetheless argues that apportionment can only be used if

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[1] This is not to say that the Due Process Clause requires a State to find that a unitary business exists before it can apportion, without modification, all federal taxable income. The issue has not been decided by this Court. See Vt. Stat. Ann., Tit. 32, § 5811 and § 5833(a).

[2] *Caterpillar Tractor Co., et al., v. Lenckos*, 84 Ill. 2d 102, 417 N.E. 2d 1341 (1981) *sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinios Department of Revenue, et al.*, prob. juris. noted __ U.S. __, Dk. No. 81-349, Nov. 9, 1981.

it is impossible to separately account for an income-producing activity. It then claims that the income in question can be separated from the income earned by its unitary business activities. However, this analysis places a double burden on the appellee and the other States; first, to adopt a method of fair apportionment and second, to prove that apportionment is necessary to tax each income-producing activity. The second burden defeats the purpose of apportionment[3] and it circumvents the real question — namely, whether the income in question is business income earned by a unitary business which operates in part in the taxing State.

B. "Business Income" Includes Income Earned On Property Which Is Acquired And Managed As An Integral Part Of A Taxpayer's Trade Or Business

Under UDITPA, the definition of business income includes income from "intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations". Ill. Rev. Stat. (1981), Ch. 120. § 15-1501(a)(1); UDITPA § 1(a). Business income is apportioned to the state according to a three-factor formula of property, payroll and sales. Ill. Rev. Stat. (1981), Ch. 120, § 3-304(a); UDITPA § 9. Appellee has enacted similar statutory provisions, and appellant has not challenged them as a matter of constitutional law. In fact, appellant acknowledges that the business income test may be

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[3] Similarly, suppose three lawyers form a partnership and agree to split equally all income and expense. After a year, if one partner claimed he should receive all of the income paid by one client because he alone represented the client, this would defeat the purpose of the partnership agreement.

appropriate in some situations, but it does not suggest any constitutional guidelines. Woolworth's Brief, P. 18-19; ASARCO's Brief, P. 18.

The Court below reviewed the factual record and found that the income in question should be classified as business income. It was earned as a result of investments in subsidiaries which were acquired and managed as integral parts of appellant's business conducted in part in the State. There is substantial evidence in the record to support this finding, and there are no "exceptional circumstances" which require a reexamination of the record on appeal. *Evco v. Jones*, 409 U.S. 91, 95 (1972); *Cal. Retail Liquor Dealers Ass'n. v. Midcal Alum.* 100 S. Ct. 937, 946-7 (1980); *Fry Roofing Co. v. Wood*, 344 U.S. 157, 160 (1952). Moreover, appellant has not challenged the application of UDITPA to the facts of its case.

The "business income" test has several characteristics. It is not the same as combined apportionment; it applies to all types of income, not just dividends; and it more than meets the due process requirement that the income be related, or minimally connected, to the business activities conducted in part in the taxing State.

Combined apportionment determines the contours or the members of a unitary business. Business income is the apportionable income earned by a trade or business. Combined apportionment is used if two or more corporations are related through common ownership and their activities are integrated with, contribute to or dependent upon each other. Business income is apportioned if the property generating the income is acquired and managed as an integral part of a corporation's trade or business. If a corporation is a member of a combined group, its business income is combined with the business income of the other members of the group, all of which is included in the combined apportionment formula. Since these are two distinct tax concepts, one should not com-

pare the results of each in an attempt to determine what is a correct or fair tax. *Infra*, p. 10. Each concept should be judged on its own merits and on the fact situation in which it is applied.

Business income, by definition, identifies the amount, and only that amount, of apportionable income a taxpayer earns in the conduct of its trade or business. It is a test of general applicability. Functional integration, on the other hand, is a test of limited applicability. It applies only to income earned on stock investments, including dividends, interest and capital gains. For instance, compare the applicability of the business income test and the functional integration test to the following situations: interest earned on working capital deposited in a bank; interest earned on loans to affiliates, see *Qualls v. Montgomery Ward Co., Inc.*, 585 S.W. 2d 18 (1979); dividends paid by an affiliated supplier like ARAMCO pays to Mobil; capital gains earned on the activity of buying and selling companies, see *Atlantic Richfield Co. v. State of Colorado*, 601 P.2d 628 (1979); income from providing management or technical services; patent and royalty income; and sales to customers. Determining what is business income in these situations will more than establish whether the income was earned in an activity related, or minimally connected, to the taxpayer's business. Deciding whether the payor and payee are functionally integrated is not determinative of whether a state may constitutionally tax these types of income. If functional integration is adopted as the exclusive test for determining apportionable income earned on stock investments, a different due process test will have to be used for the types of income outlined above. But *Mobil* expressly decided that there was nothing about the nature of dividend income which distinguished it, in a due process sense, from the other income which a state may tax.

One requirement of the Due Process Clause identified in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), is that there be a "minimal connection" between the interstate activities and the taxing State. *Mobil* stated that income earned by activities unrelated to the taxpayer's business may escape an apportioned tax. Income earned from property which was acquired and managed as an integral part of a taxpayer's business certainly falls within this constitutional framework.

THE FACTORS IN THE APPORTIONMENT FORMULA DO NOT NEED TO BE ADJUSTED

A. Appellant Has Not Shown By Clear And Convincing Evidence That Extraterritorial Values Are Being Taxed

Appellant contends that under *Mobil* if appellee apportions dividends, it must include some percentage of the property, payroll and sales of the payor in the payee's apportionment formula.[4] It argues that if this adjustment is not made, the formula will be "inherently arbitrary" and it will necessarily overstate the income properly attributable to the State. Appellant claims to have met its burden of proving that extraterritorial values are being taxed by claiming that the appellee's method results in a higher tax liability and by using a hypothetical example to show that receiving dividends from a sub-

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[4] This assumes that the dividends represent income earned by the payor and that the apportionment formula must reflect the factors which generate the income. This proposed adjustment is a hybrid of combined apportionment. It is impossible to reconcile this position with appellant's statement that it agrees with the position against combination taken by the appellant in *Chicago Bridge & Iron Co., supra*. See ASARCO Brief, p. 31; Woolworth Brief, p. 37. In effect, appellant is asking this Court to authorize an adjustment which it thinks is unconstitutional.

sidiary will result in a higher tax than receiving income from a division.

At the outset, one should remember that the income being taxed was earned from the activity of acquiring and managing intangible property which is integral to the taxpayer's business conducted in part in the taxing State. The three factor formula already reflects the property, payroll, sales and expense attributable to this activity. The sales factor includes the dividends received. The payroll factor includes the salaries of the employees and officers who make and manage the investments. The property factor includes the office space and equipment necessary for conducting this activity. Appellant's business income has been reduced by the expenses of acquiring, managing and disposing of its investments, e.g. salaries, office supplies and equipment, travel, communication, and interest on indebtedness that otherwise would not have been incurred but for the stock investment. If the income in question really is nonbusiness income, all of these items should be excluded from the apportionment formula. Appellant has not offered to do this, undoubtedly because it would be impossible to separate these items from its other business activities.

A taxpayer who attacks an apportionment formula must show by clear and cogent evidence that it results in taxing extraterritorial values. *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). Appellant claims to have met this burden by noting that the formula will cause the percentage of its tax liability (not amount) to increase significantly and by using a hypothetical example to show that receiving dividends from a subsidiary will result in a higher tax than receiving income from a division. These two pieces of evidence are neither clear nor convincing. The fact that there is a difference between what the parties think the tax should be does not prove or disprove which party is correct. The hypothetical example

used by appellant is faulty, as will be shown, for several reasons: the taxation of dividends and the use of combined apportionment are not comparable; the amount of dividends paid each year are not related to the property, payroll and sales of the payor; and other examples can be used to show the tax avoidance and illogical consequences caused by the proposed adjustments.

First, as was mentioned earlier, the taxation of dividends and the use of combined apportionment are separate and distinct tax concepts. The former depends upon the relationship between the purpose of the investment and the business activity of the taxpayer; the latter depends upon common ownership and the extent of integration, contribution and dependency among the corporations. The former apportions dividends received by the payee; the latter apportions the income of the payor and the other members of the combined group. Contrary to appellant's interpretation, *Mobil* did not equate the two concepts. *Mobil* did say that the propriety of apportionment depends upon the underlying economic reality among corporations rather than divisional or corporate lines. This was in the context of finding that Mobil's investment activities were not separate from its other business activities. It was not in the context of requiring states to adjust their apportionment formulas in order to reach results similar to combined apportionment. In fact, *Mobil* expressly did not decide whether the apportionment formula should be adjusted or whether combined apportionment is required.[5] Also, *Mobil* allowed dividends from affiliates to be apportioned and affiliates are not usually considered to be part of the

[5] It is noteworthy that the use of combined apportionment is authorized in appellee's State. If the relationship between the parent and subsidiary had warranted it, appellant could have obtained the adjustment it now requests by using the combined report.

combined group. This means that, as a matter of law, appellant is not entitled to an adjustment in the formula whenever investment income is apportioned.

Second, the hypothetical example and the proposed adjustment are misconceived because they presume that the dividends, like net income, are related to the property, payroll and sales of the payor. They are not because the amount of dividends paid by a corporation is usually less, but may be more, than current net income. The net income available for dividends is first reduced by federal, state and foreign taxes and reserves for expansion. Also, accumulated earnings and profits limit the amount of taxable dividends which may be distributed. See I.R.C. § 312; BNA Tax Management Portfolios, *Earnings and Profits,* 175-2nd. In theory, if the income of the payor includes dividends received from its subsidiaries, then the earnings and profits of these second-tier corporations would also affect any factor adjustment. Appellant's reason for adjusting the apportionment formula is that the factors should reflect the "source" of the dividend income. While property, payroll and sales reasonably reflect the income-producing activities of the payor, they do not reasonably reflect the dividends paid since they are not related to the net income and the earnings and profits otherwise available for distribution. Thus, appellant has not proposed a conceptually sound adjustment.[6]

Different hypothetical examples can be used to show that appellant's proposed adjustment can be used to avoid taxes and that it causes illogical consequences. The Idaho State Tax Commission's brief demonstrates how the proposed ad-

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[6] Appellant has not suggested how the formula should be adjusted for interest and capital gains. This reflects a severe deficiency in the rationale for why an adjustment is needed in the first place.

justment can exempt dividends or even reduce otherwise taxable income, depending on the size of the payor's three factors relative to the payee's three factors. That brief also illustrates how the proposed adjustments could attribute part of a taxpayer's income to jurisdictions in which it conducts no business activities and in which it could not be taxed. The Brief of *Amicus Curiae* Multistate Tax Commission provides examples which show that there is no equivalence in tax between the use of a combined report and the inclusion of the payor's factors in the payee's denominators.

B. A State Tax On Domestically-Earned Income Derived From Domestically-Owned Property Which Is Related To Both Domestic And Foreign Business Activities Does Not Invoke The Foreign Commerce Clause

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 99 S. Ct. 1813 (1979), involved cargo containers that were "owned, based and registered abroad and that [were] used exclusively in international commerce," 99 S. Ct. at 1819. In an effort to address this narrow question, this Court declined to revive the "home port doctrine," and it did not reach the questions as to the taxability of foreign-owned instrumentalities engaged in interstate commerce or of domestically-owned instrumentalities engaged in foreign commerce. *ibid*

The instant case involves income earned and property owned by a domestic corporation which conducts both interstate and foreign activities. The property is intangible, and it is an integral part of appellant's business. Since appellant conducts business in other jurisdictions as well as the taxing State, the intangible property does not have a fixed situs, nor is the income treated as having a single source.

Japan Line involved foreign-owned tangible property which was used exclusively in international commerce. This case involves domestically-earned income derived from domestically-owned intangible property which is an integral part of a business with both interstate and foreign activities. Appellant has not demonstrated that the State tax is imposed on foreign commerce, and this is a prerequisite to any argument premised on the two precepts enunciated in *Japan Line*.

Japan Line found that a local tax was prohibited where actual multiple taxation was established and where a treaty between the United States and Japan expressly prohibited the tax in question. This Court should find that the tax is permitted, not only because it is not imposed on foreign commerce, but because there is no evidence of multiple taxation in fact and there is no federal statute or treaty which prohibits the state tax. In addition, appellant has not shown that the tax is discriminatory. The State tax reaches all dividends included in both federal taxable income and business income regardless of whether they are paid by domestic or foreign corporations. The fact that part or all of some dividends are deducted in computing federal taxable income whereas other dividends are adjusted by way of a federal tax credit is a matter of federal law and elections made by a taxpayer. See I.R.C. §§ 78, 243-246, 901-908, 951-964. The State statute does not subject foreign commerce to a different burden of taxation than domestic commerce. Also appellant has not shown that the State tax is "inimical to the national commerce" such that this Court should act where Congress has not acted. In fact, if this Court adopted appellant's argument, it would infer a constitutional preference for allocation of dividend income to a foreign situs rather than apportionment among the States. This is what the Court refused to do in *Mobil*.

CONCLUSION

For the foregoing reasons, *Amicus Curiae* State of Illinois respectfully request this Court to affirm the decision of the Court below.

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No. 80-1745

In The

Supreme Court of the United States

October Term, 1980

F. W. WOOLWORTH CO.,

Appellant,

vs.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,

Appellee.

On Appeal from the Supreme Court of New Mexico

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COUNTER-STATEMENT OF QUESTIONS PRESENTED

1. Whether the Uniform Division of Income for Tax Purposes Act (UDITPA) contravenes either the due process clause (Amend. XIV, § 1) or the commerce clause (Art. I, § 8 cl. 3) of the Constitution of the United States to the extent it requires the inclusion of income from stock investments in apportionable income when these investments are acquired and managed by the taxpayer in connection with its multistate trade or business operations.

2. Whether the apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), without modification, contravenes either the due process or commerce clause of the United States Constitution in requiring the apportionment of all business income under the UDITPA three-factor (tangible property, payroll and sales) apportionment formula when business income includes income from investments in stock and when the taxpayer has offered no proof that the formula attributes any net income to the taxing state which is not reasonably related to its instate activities and properties as required by UDITPA § 18[1].

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[1]N. M. Stat. Ann. 1981 (hereinafter N. M. S. A.) § 7-4-19; 7A Uniform Laws Annotated 106 (1978).

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INTRODUCTORY STATEMENT

This brief is submitted by the Multistate Tax Commission (hereinafter called the Commission) in support of the Appellee. The parties to this proceeding have consented to the filing of this brief.[2]

STATEMENT OF INTEREST

The interest of the Commission and the states participating in this cause are identical to their interest as set forth in their *amicus* brief in *ASARCO, Inc. v. Idaho State Tax Comm'n,* No. 80-2015, which will be considered in tandem with this case. Therefore, to repeat that statement here would be unduly repetitious. As in *ASARCO,* our interest in this case is that the apportionment provisions of UDITPA, and comparable state income tax attribution provisions, be upheld as constitutional since they apply the unitary business principle in a rational and reasonable manner. Neither the due process clause nor the commerce clause prescribes additional standards for the inclusion of income from stock investments or other intangibles in apportionable income than for the inclusion of other income of the taxpayer. In our judgment, all of the income from intangibles acquired and held in connection with a taxpayer's unitary business can be apportioned, for state income tax purposes, among the various taxing jurisdictions where the taxpayer conducts its unitary business, as required by a reasonable interpretation and application of UDITPA. This brief is filed in support of this position.

COUNTER STATEMENT OF THE CASE

The Commission accepts Woolworth's Statement of The Case except that it *disagrees* with Woolworth's state-

[2]Originals of the consent letters have been filed with the Clerk of the Court.

ments pertaining to its relationship with its four subsidiaries (from which it received the dividends in question) and with the statement's omission of important facts. These facts, concerning Woolworth's relationship with its subsidiaries, are set forth in the opinion below (J. S. at 8a-9a). Based on these facts and its examination of the entire record, the New Mexico Supreme Court concluded that there were sufficient unitary relationships between Woolworth and those subsidiaries to establish that Woolworth's stock investments in these subsidiaries were related to Woolworth's unitary business (J. S. at 19a). This conclusion is amply supported by the transcript of the proceedings below.[3]

As to these relationships, it is important that Woolworth does not claim that it did not conduct all of its own

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[3]Woolworth's foreign subsidiaries, under the Woolworth name (J. A. at 22a), conducted the same type of retail operations as Woolworth (J. A. at 21a). Woolworth's overall financing and planning included and was integrated with that of its foreign subsidiaries (J. A. at 27a-28a). There was a substantial exchange of business information between Woolworth and its foreign subsidiary corporations through a teletype communications system and travel of executive personnel (J. A. at 34a-36a). This was particularly true with regard to major decisions (J. A. at 37a). Any substantial borrowing of the foreign subsidiaries or other major decisions or transactions required approval of Woolworth (J. S. at 49a). To what extent there was a flow of goods between Woolworth and its domestic subsidiaries is not known (J. A. at 44a-45a). However, there was a flow back and forth of financial resources (J. A. at 45a). While the record is not clear as to the actual degree of control Woolworth's board of directors exercised over its foreign subsidiary corporations, it did oversee these operations (J. A. at 49a). Responsibilities were given to them by Woolworth only commensurate with the development of their abilities to act independent of Woolworth (J. A. at 45a). Also, there were interlocking directors and executive personnel between that of Woolworth and its foreign subsidiaries (J. A. at 29a-30a). The managing directors of the foreign subsidiaries were selected by Woolworth (J. A. at 32a). The dividend policies of the subsidiary and affiliated corporations in question were determined by Woolworth (J. A. at 33a).

business operations as a single unitary business or that the dividends in question did not result from stock investments which were rationally related to this business which it conducted in part in New Mexico for the year in question.[4] Nothing in the record indicates otherwise or establishes that the UDITPA apportionment formula, as applied to Woolworth's total income from its unitary business, assigns any income to New Mexico not rationally related to Woolworth's New Mexico activities for the year in question.[5] Further, Woolworth has never contended that it should be permitted to file its return in question on the "combined reporting" method. Neither has it shown what would be the results of a "combined report." Rather, Woolworth argues as an abstract proposition that a "combined report," which includes foreign subsidiaries, is unconstitutional (Appellant's Br. at 37).

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SUMMARY OF ARGUMENT

Beginning with the early *ad valorem* property tax case of *Adams Express Co. v. Ohio State Auditor*, 165

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[4]For a more complete statement of these ties for prior years, see *F. W. Woolworth Co. v. Director of Taxation*, 45 N. J. 466, 213 A. 2d 1 (1965).

[5]For the year in question in New Mexico, Woolworth had tangible property of $8,750,664, sales of $13,253,425 and payroll of $1,996,950 (J. A. at 57a). The net income attributable to New Mexico after inclusion of the disputed items in apportionable income was $401,518 (J. A. at 69a). This net income attributable to New Mexico represents 4.6% return on Woolworth's tangible property and 3% return on its sales in New Mexico. If the items in question are excluded, the New Mexico taxable net income is reduced to $84,622 which represents only .97 of 1% return on tangible property and .64 of 1% return on sales in New Mexico. A comparison of the result when the income in question is included to the result when the income in question is excluded, Appellant's Br. at 7, does not establish that the inclusion of the income in question in apportionable income results in taxation by New Mexico of extra-territorial values or income. A 4.6% return on tangible property and a 3% return on sales is not *per se* unreasonable.

U. S. 194, *rehearing,* 166 U. S. 185 (1897) through *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U. S. 207 (1980), this Court has uniformly sustained reasonably apportioned state taxes imposed on property, corporate franchises or net income. These holdings stand for the principle that states are free to use the unitary business principle in apportioning income or values. This Court has never limited the apportionable tax base to instate values, properties or income. *Exxon, supra; Mobil Oil Corp. v. Commissioner of Taxes,* 445 U. S. 425 (1980); *U. S. Steel Corp. v. Multistate Tax Comm'n,* 434 U. S. 452, 473 nn. 25 & 26 (1978); *Butler Bros. v. McColgan,* 315 U. S. 501 (1942); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n,* 266 U. S. 271, 282 (1924); *Underwood Typewriter Co. v. Chamberlain,* 245 U. S. 113 (1920). It has recognized that "net income taxes", unlike gross receipts taxes, are not imposed on specific transactions from which net income may be derived. *N. Y. ex rel. Cohn v. Graves,* 300 U. S. 308, 312 (1936); *N. Y. Peck & Co. v. Lowe,* 247 U. S. 165 (1918). Unitary apportionment is valid even though applied to income from foreign activities of a foreign corporation. *Bass, Ratcliff & Gretton, Ltd., supra.*

The Court has recognized that the possession of large blocks of intangible properties gives value to a business, in conducting instate activities, which can be considered in imposing a state tax on instate activities. *Ford Motor Co. v. Beauchamp,* 308 U. S. 331, 336 (1939) (citing *Bass, supra; National Leather Co. v. Massachusetts,* 227 U. S. 413 (1928)); *National Leather Co. v. Massachusetts,* 277 U. S. 413 (1928); *Flint v. Stone Tracy Co.,* 220 U. S. 107 at 166 (1911). It has recognized that intangibles may be taxed where they have a "business situs". *First Bank Stock Corp. v. Minnesota,* 301 U. S. 234 (1937); *Wheeling*

Steel Corp. v. Fox, 298 U.S. 193 (1936). The Court has further held that a state may tax intangibles if it confers any benefits in regard to the ownership or use of the intangibles. *Curry v. McCanless*, 307 U.S. 357 (1939); *Liverpool Ins. Co. v. Orleans Assessors*, 221 U.S. 346 (1911). It has applied no different rule as to stocks. *First Bank Stock Corp. v. Minnesota, supra; Adams Express Co. v. Ohio State Auditor, supra.*

The Court has consistently placed the burden on the *taxpayer* to *prove* (1) that a state taxing statute is unconstitutional, *Mobil*, 445 U.S. at 442; *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537 (1951), and (2) that the tax is imposed on transactions which are disassociated from instate activities, *Norton Co., supra.* It has consistently refused to engage in abstract hypothetical reasoning for these purposes, *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 276 (1978). It has also held that it is presumed that all of a corporation's properties contribute to the operations of its entire business, and that intangibles which are associated with a unitary business are properly attributable to where that business is done. *Adams Express Co., supra.*

The Court has repeatedly recognized that apportionment is only a method used to roughly approximate income attributable to a taxing jurisdiction and that it does not purport to identify or tax any specific income derived from identifiable sources. *Exxon, supra; Mobil, supra; Moorman*, at 278-80 (1978). It has invalidated an apportionment formula only when the taxpayer has established by clear and cogent evidence that the formula resulted in the taxation of extra-territorial income or values. *Moorman, supra; Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682 (1968); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).

The Court has held that any prohibited risk of multiple taxation under the commerce clause is satisfied by reasonable apportionment rules. *Mobil, supra; Japan Line Ltd. v. Los Angeles,* 441 U.S. 434 (1979); *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 448-49 (1959).

In sum, the Court has concluded that a state tax conforms to the due process and commerce clauses if the tax (1) is fairly apportioned and non-discriminatory; (2) is applied to an activity with a nexus in the state; (3) is designed to reasonably compensate the state for services provided; (4) is rationally related to instate activities; and (5) furthermore, there is a rational relation in regard to the property, value or income of a multijurisdictional unitary business when the entire property, value or income of such a business is apportioned unless the taxpayer can show the apportionment result reaches extra-territorial values, property or income. *Mobil, supra; Exxon, supra; Japan Line, supra; Moorman, supra.* A state tax that reaches intangible values or income has triggered no additional constitutional restrictions.

The UDITPA apportionment provisions, on their face and as applied by the court below, conform to the foregoing constitutional principles. These provisions only require the apportionment of income which is rationally related to the taxpayer's unitary business which is conducted in part in the taxing state by the well recognized three-factor apportionment formula. (*Butler Bros., supra,* upheld this formula as applied to the total unitary business income of the taxpayer). Furthermore, since UDITPA provides for apportionment relief[6] if the income

[6] I. C. § 63-3027 (r); UDITPA § 18. See the Commission's *amicus* brief in *ASARCO* at 7 for a discussion of this apportionment relief provision.

apportioned to a state is not reasonably related to the taxpayer's instate activities, UDITPA conforms to the due process limitations of *Hans Rees' Sons, Inc., supra.* The court below applied these provisions consistent with the foregoing statutory requirements.

Without directly challenging the above controlling constitutional principles, Woolworth here argues that *Mobil* imposes additional due process limitations on state taxing powers when income from stock investments are included in apportionable income. In addition, Woolworth argues that *Japan Line, supra,* imposes additional commerce clause limitations if income from stock investments in foreign corporations is included in apportionable income. However, *Mobil* upheld the apportionment of dividends in accordance with the foregoing general constitutional principles and further held that *Japan Line,* was irrelevant to state net income tax apportionment cases. 445 U. S. at 448.

Woolworth's argument that *Mobil* invalidates the lower court's decision, apart from its misinterpretation of *Mobil* and *Japan Line,* is premised on two basic misconceptions. First, it confuses the dividend income of a payee corporation with the payor corporation's net taxable income for the current tax year. It ignores the fact that the taxpayer whose earnings are being apportioned is the payee who holds the stock investments in connection with its own unitary business. Second, it assumes that the attribution of income from stock investments (and presumably other intangibles) to the unitary business activities of the payee corporation by the apportionment factors of UDITPA will inevitably produce an arbitrary result (Appellant's Br. at 11, 38, 41). It has otherwise not sought to show why due process is violated by the decision below. Therefore, Woolworth has not sustained its

burden of proving that the decision below contravenes constitutional limitations.

ARGUMENT

I. The UDITPA Apportionment Formula Conforms to Due Process Limitions and Is Not "Inherently Arbitrary" as a Matter of Law When it Requires the Apportionment of All the Business Income of a Taxpayer, Including Income from Intangibles: It Is Reasonable to Apportion All Business Income to Where the Business is Done as Reflected by the Location of the Tangible property, Payroll and Sales of the Business.

As noted by this Court in *Exxon:*

> The Due Process Clause of the Fourteenth Amendment imposes two requirements for such state taxation: a "minimal connection" or "nexus" between the interstate activities and the taxing State, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes, supra,* at 436, 437.

Since there is no question of taxable "nexus" or disproportionate taxation here, the only due process issue is whether the UDITPA apportionment provisions, as applied, attribute net income to New Mexico which is rationally related to Woolworth's instate business activities. A net income tax is rationally related to a taxpayer's instate business activities, if the entire net income of a unitary business, which is conducted in more than one taxing jurisdiction, is apportioned among the taxing jurisdictions in which the business is conducted, unless the taxpayer can establish by clear and cogent evidence that the apportionment formula, as applied, taxes extra-territorial values or income. *Underwood Typewriter Co.,* 254 U.S. at 121; *Bass, Ratcliff & Gretton, Ltd.,* 266 U.S. at 283; *Butler Bros.,* 315 U.S. at 509; *Northwestern States Portland Cement Co.,* 358 U.S. at 464-65;

Moorman Mfg. Co., 437 U. S. at 273; *Mobil Oil Corp.*, 445 U. S. at 436-37; *Exxon Corp.*, 447 U. S. at 207; *Hans Rees' Sons, Inc.*, 283 U. S. at 123. The fact that apportionable income includes income from intangibles, does not result, *per se*, in the taxation of values or income which is not rationally related to the instate business of the taxpayer since intangibles and income from intangibles may be rationally related to the taxpayer's entire unitary business. *Adams Express Co., supra; Ford Motor Co., supra; Flint, supra; Butler Bros., supra; Mobil, supra; Northwestern Portland Cement Co., supra; National Leather Co., supra*; *Great Lakes Pipeline Co.*, 272 Minn. 403, 138 N. W. 2d 612 (1965); *Cleveland Cliffs Iron Co. v. Corporation & Sec. Comm'n*, 351 Mich. 652, 88 N. W. 2d 564 (1958). Nor does the UDITPA apportionment formula, so applied, *per se* attribute income or values to a taxing state which is not rationally related to instate values, if intangibles are not included in the apportionment formula. *Adams Express, supra; Ford Motor Co., supra; Mobil, supra; National Leather Co., supra.*

UDITPA apportions "business income," based on a comparison of the instate activities of a trade or business to the total activities of the trade or business, by the well recognized three-factor apportionment formula (the average of the three factors of tangible property, payroll, and sales). "Business income" is defined in UDITPA § 1(a) as only that income produced by property and activities which are rationally related to the trade or business.[7] UDIPTA apportions all classes of income by the

[7]UDITPA § 1 (a) defines "business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations (N. M. S. A. § 7-4-2 (A)).

three-factor formula on the fundamental premise that all income from property and activities which are rationally related to the trade or business is reasonably and constitutionally attributable to where that business is done as reflected by the location of the tangible property, payroll and sales (receipts) of that business.

Consistent with UDITPA §1(a), the Commission UDITPA advisory regulations,[8] which have been adopted or followed by most of the states, including New Mexico,[9] set forth general guidelines to determine when various classes of income are to be apportionable as "business income" or allocated as "nonbusiness" income.[10] These regulations provide that rents and royalties from real and tangible property, capital gains, interest, dividends and patent and copyright royalties are apportionable as business income in accordance with the same standard: Whether these classes of income derive from properties rationally related to the taxpayer's trade or business operations.[11]

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[8]7 Multistate Tax Comm'n Ann. Rep. app. J at 64-69 (1973-1974).

[9]N. M. Income Tax Reg. 17.

[10]UDITPA §§ 4 to 8 and N. M. S. A. §§ 7-4-5 to -9 provide for the specific allocation of rents and royalties from real or tangible property, capital gains, interest, dividends or patent or copyright royalties to the extent that they constitute nonbusiness income; that is when these items of income are not rationally related to the unitary business of the taxpayer.

[11]In general, these regulations provide:

> all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (7 Multistate Tax Comm'n Ann. Rep. app. J at 64).

Regarding the classification of dividends as business income, the Commission's UDITPA regulations state in part:

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Notwithstanding the fact that UDITPA only apportions income that is rationally related to a multi-jurisdictional unitary trade or business, Woolworth here argues that its apportionment provisions are unconstitutional because they "will 'inevitably' produce an arbitrary result," (Appellant's Br. at 41), and are "patently arbitrary," (*Id.* at 38),

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Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations.

. . . .

Example (ii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are Lusiness income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income. (*Id.* at 68.)

when applied to apportionable income which includes income from stock investments.[12] However, the due process clause does not preclude the apportionment of intangible values or income which arise out of and are used in connection with a unitary business. In addition, nothing in the due process clause indicates that the apportionment of intangible values or income of a unitary business to where the business is done as reflected by tangible factors (tangible property, payroll, and sales) attributes extra-territorial values to the taxing state or is otherwise "patently arbitrary."

These twin principles were decided in 1897 in *Adams Express, supra.* They give constitutional recognition to the fact that intangible properties and values of a multi-state-multinational corporation, which arise out of and are connected with its unitary multi-jurisdictional business, are rationally related by tangible factors to where that business is being conducted. In *Adams Express, supra,* the Court upheld the apportionment of intangibles of a unitary business, which was conducted in numerous states, to where that business was done as reflected by the location of the tangible property of that business. The *Adams Express* court noted that a contrary contention "practically ignores the existence of intangible property, or at least denies its liability for taxation." 166 U. S. at 218.[13]

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[12]Presumably, this UDITPA standard, under Woolworth's reasoning, would also be unconstitutional as applied to other classes of income from intangibles such as income from patents, copyrights, bonds, and interest, etc. It so argues here in regard to exchange currency gains. Appellant's Br. at 40. ASARCO argues likewise in No. 80-2015 in regard to interest and gains from the installment sale of stocks.

[13]The substance of Woolworth's argument is that intangibles have no taxable value and produce no taxable income to the owner of the intangibles. Rather, Woolworth would at-

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The principles of *Adams Express* have been followed in all *ad valorem* property tax apportionment cases[14] as well as other state tax apportionment cases.

The foregoing principles were also recognized and applied by the Court in the "net worth" franchise tax cases of *Beauchamp, supra,* and *National Leather Co., supra. Beauchamp* upheld the apportionment of the entire "net worth" of Ford Motor Co. "calculated by the percentage of sales which are within the state," 308 U. S. at 335, although the "net worth" apportioned to the taxing state was many times greater than the value of the property located there. *National Leather Co.* (relied upon in *Beauchamp, supra,* 308 U. S. at 335-336) upheld a corporate privilege tax based on the fair cash value of stock, including the value of stock in subsidiary corporations, because the stocks were utilized by National Leather in the conduct of its business (the unitary business principle) even though the stock presumably had no taxable situs in the taxing state.

The development of state taxation of intangibles for state property tax purposes is analogous to the above "net worth" privilege and property tax cases. Intangibles for this purpose were held taxable on the basis of the "business situs" principle. Under this principle, a taxing state could tax intangibles which were associated with the taxpayer's business in the state. *State Tax Comm'n v. Ald-*

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tribute intangibles to the underlying tangible property and income-producing activities of the payors. This follows from Woolworth's argument that dividends are apportionable only when the business of the payors are unitary with the payee and, in that event, the dividends are, in substance, apportionable to the payors by the inclusion of their apportionment factors in the denominator of the payee's apportionment factors.

[14]*See, e. g., Norfolk & Western Ry. Co. v. Missouri State Tax Comm'n,* 390 U. S. 317 (1968); *Wallace v. Hines,* 253 U. S. 66 (1920); *Cleveland, Cincinnati, Chicago & St. Louis Ry. Co. v. Backus,* 154 U. S. 439 (1894).

rich, 316 U. S. 174 (1942); *Wheeling Steel Corp, supra; Liverpool Ins. Co., supra; First Bank Stock Corp., supra.* This principle was extended to permit intangibles to be sitused and taxed in full by any state that conferred any benefit related to their ownership. *Curry v. McCanless, supra.* Multiple state taxation of intangibles was thus possible under the due process clause since several states could confer some benefit in regard to an owner's interest in intangibles.[15]

To prevent multiple taxation of intangibles which are used in the conduct of a business both within and without the state, it is fair to apply the unitary business principle to apportion the intangibles to where the taxpayer conducts the business with which the intangibles are associated.[16] This is simply a logical application of the "busi-

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[15]See, Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 Vand. L. Rev. 401 (1976).

[16]This simply recognizes the equities in the taxpayer's argument in *Wheeling Steel Corp., supra*, where the taxpayer argued that the intangibles in question (trade account receivable) should be apportioned because they were connected with business activities in more than one state. The *Wheeling* Court recognized the validity of this argument in the context of state net income taxes, although it held that the state where the intangibles had acquired a "business situs" could tax the full value of intangibles under the due process clause. 298 U. S. at 212.

Michigan decisions illustrate the reasonableness of apportioning dividends to avoid duplicate taxation. The Michigan Intangible Tax Act, which required apportionment of intangibles by a logical extension of the "business situs" principle, was before the Supreme Court of Michigan in *Cleveland-Cliffs Iron Co. v. Department of Revenue*, 329 Mich. 225, 45 N. W. 2d 46 (1950). The Michigan statute (quoted at 329 Mich. at 237-38) required intangibles to be apportioned by the three-factor formula of tangible property, payroll and sales if the intangibles were connected with a unitary business conducted within and without the state. Although the Court held that the intangibles there in question had no apportionable situs in

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ness situs" principle in a manner which conforms to the unitary business principle. Consistent with this, this Court has required the apportionment of movable tangible property which had a taxable *situs* in more than one state for *ad valorem* property tax purposes. *Standard Oil Co. v. Peck*, 342 U. S. 382, 384 (1952).

Although, apart from *Mobil, supra,* no decision of this Court has focused on the specific question of the apportionment of income from intangibles for state income tax purposes, the Court's net income apportionment cases have uniformly held that all of the net income of a unitary business conducted in more than one jurisdiction is properly apportioned by tangible apportionment factors to where the business is done in the absence of a showing by clear and cogent evidence that extra-territorial values are subject to tax. *Exxon, supra; Moorman, supra; Northwestern States Portland Cement Co., supra; Butler Bros., supra*; *Hans Rees' Sons, Inc., supra; Bass, Ratcliffe & Gretton, Ltd , supra; Underwood Typewriter Co., supra. Mobil* held likewise in regard to the apportionment of dividends.[17]

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Michigan because they were not found to be a part of the iron company's unitary business, no question was raised as to the reasonableness of apportioning intangibles to avoid double taxation. *Cf. E. F. MacDonald Co. v. Department of Treasury,* 62 Mich. App. 626, 233 N. W. 2d 678 (1975). See the well reasoned case of *Cleveland-Cliffs Iron Co. v. Corporation & Sec. Comm'n,* 351 Mich. 652, 88 N. W. 2d 564 (1968), where the court upheld a net worth franchise tax which used a three-factor formula to apportion the instate value of the privilege of doing business in the state, including the value of stock investments which were at issue.

[17]For a discussion of *Mobil,* see text at division V pages 25-29, infra. No basis exists to employ a different due process constitutional standard here. In fact, we know of no standard which is more reasonable or equitable, either to the taxpayer or the taxing jurisdictions.

The Commission and participating states strongly believe that the above analysis, which illustrates that UDITPA is constitutional, answers the due process question raised in the case at bar. Assuming, *arguendo,* that this analysis does not prevail, we will next respond to Woolworth's defective arguments.

II. The Due Process Clause Does Not Limit the Apportionability of Dividends or Other Income from Intangible Property, Including Dividends, to Income Received by a Payee from Payors Which Conduct Business Which is Related to the Business of the Payee Since Such Income Otherwise May Be Rationally Related to the Payee's Unitary Business.

Stocks, bonds, receivables, patents, copyrights, etc., acquire a taxable situs in the hands of the owner, apart from the underlying property activities or other considerations which give them value. *Curry v. McCanless, supra; Wheeling Steel Co. v. Fox, supra.* Furthermore, there is no due process reason to assign the income from such intangibles to the activities of the income payors any more than there would be to assign the income from the rental of tangible property to the activity of the payor of the rent. In each instance ownership and use of the property generates income to the owner. For UDITPA purposes, the controlling question is whether the property and the income produced by the property is related to and is used in connection with the taxpayer's own unitary business operations. This may be illustrated by the examples (ii) and (iv) in footnote 17, *supra,* and by the following example:

1. Assume Corp. A invests in stocks and bonds and notes receivable to provide for necessary liquidity in the conduct of its business and to generate supplemental income to meet fluctuating business needs. In this example, a rational relationship exists between these investments and Corp. A's

> business which supports the apportionability of the value of these investments and the income generated by them to where Corp. A's business is being conducted.

These examples illustrate that there can be a myriad of business purposes rationally related to or connected with a corporation's stock investments where the corporations in which the investments are made do not conduct any activity which is related to that of the investing corporation.

Furthermore, a corporation may invest in stocks, bonds, or miscellaneous obligations of other corporations for purposes rationally related to the business activities of the other corporations where the investing corporation is not conducting a unitary business with the other corporations. This can be illustrated by examples (iii) and (iv) in footnote 11, *supra,* and by the following example:

> Corp. C is a national retailer with retail establishments located in various shopping centers throughout the United States. In order to participate and be advised of the development of shopping centers, it invests in the stock of Corp. D whose business is developing shopping centers. Although no unitary business exists, Corp. C's investment is directly related to its business of retailing and Corp. D's development business.

Thus, Woolworth's construction of the due process clause is illogical and inconsistent with the unitary-business principle: Investments in stock can obviously be made for many purposes which are rationally related to the taxpayer's unitary business, without the taxpayer conducting a unitary business with the payor corporations.[18]

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[18]Woolworth recognizes this in reference to a dealer in securities and other "situations not considered in *Mobil* and not present here." (Appellant's Br. at 18-19). It would distinguish its situation from a securities dealer because "here, there is no evidence that the taxpayer's business consists of, or necessarily involves, security investments." *Id.* The logic of this argument and its factual assumption escapes us.

III. Woolworth's Arguments Are Based on the Untenable Premise that Dividends, for State Income Tax Apportionment Purposes, Can Never be Apportioned as the Income of the Recipient, since, to the Extent Dividends are Included in Apportionable Income, Woolworth Argues That They Must Be Attributable to the Underlying Profits and Activities of the Payor Corporations.

If this Court affirms Woolworth's position, in substance, it would be required to conclude that dividends are not the recipient's taxable income for apportionment purposes since, if apportionable, they must be attributable to the business activities of the payor corporations.[19]

Apart from its unsupportable interpretation of *Mobil* (which we consider, *infra* at pp. 25-29) Woolworth has cited no authority in support of its position, which must be based on the premise that the inclusion of dividends in apportionable income is the taxation of the profits of the dividend payor corporations.[20] This argument confuses the dividend income of the payee stockholders with the net taxable income of the payor corporations. It ignores the fact that the taxpayer whose earnings are being taxed is the payee who holds the stock investment in connection with its own unitary business. Inasmuch as stockholders and the corporations in which they own stock are distinct taxable legal entities, this argument has no constitutional

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[19]Woolworth is thus asking this Court, as a practical matter, to overrule *Mobil*. For, consistent with this argument, Mobil's dividends held apportionable in *Mobil*, should be attributable to the payors of the dividends.

[20]This is a novel and far-reaching construction of the due process clause and, if relevant in regard to the attribution of dividends, it is equally relevant in the attribution of other classes and sources of income from intangible property. Woolworth's position conflicts with this Court's holding in *Mobil* that Vermont was entitled to tax "a proportionate share of . . . dividend income." 445 U. S. at 446.

validity. See *Hawley v. Madden*, 232 U. S. 1 (1914); *Darnell v. Indiana*, 226 U. S. 390 (1912).[21]

The substance of this argument was rejected in *First Bank Stock Corp., supra*, and cases cited therein. *First Bank Stock Corp.* held that stock and other intangibles which are used in the business of the owner may acquire a taxable "business situs" where they are used in that business. 301 U. S. at 237. In applying the unitary business principle, the Court refused to distinguish the taxation of stock from the taxation of other intangibles and it refused to hold that stock has a taxable situs only at the location of the issuing corporation. *Accord, National Leather Co., supra*, where the Court rejected the taxpayer's argument that stock values should be attributable to the properties and activities of the issuing corporations. Furthermore, the decisions in both *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435 (1940), and *Harvester Co. v. Department of Taxation*, 322 U. S. 435 (1944), assumed that the states in which the stockholders were located could constitutionally tax the dividends, irrespective of where the activities of the payor corporations were conducted. As noted in the dissent in *Harvester*, "[t]hese dividends, of course, are income to the stockholder, and any state with jurisdiction to tax him may tax them as such." 322 U. S. at 448.

Intangibles, including stock can acquire a taxable business situs even for property tax purposes. *Wheeling Steel, supra*. They may be apportioned on the basis of the busi-

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[21] In fact, this is arguing that dividends must be apportioned only as sustained by this Court in *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435 (1940), and *Harvester Co. v. Department of Taxation*, 322 U. S. 435 (1944). In these cases, this Court upheld Wisconsin's power to apportion dividends as profits of the payor corporations which were attributable in part to their activities in the taxing state.

ness activities of the owner of the stock by a tangible property factor. *Adams Express*, 166 U. S. at 222.

Thus, Woolworth's due process apportionability argument is frivolous.

IV. Woolworth Has Not Established that, Under the Due Process Clause, It Is Entitled to Any Modification of the UDITPA Apportionment Formula if the Income from the Investments in Question are Included in Apportionable Income, Since It Has Failed to Sustain Its Contention that the UDITPA Apportionment Formula Attributed to New Mexico Any Net Income Which is not Rationally Related to its New Mexico Business Activities.[22]

Woolworth argues that if some portion of its income from the stock investments in question may constitutionally be included in the apportionable income, due process requires a modification of the UDIPTA apportionment formula (Appellant's Br. at 32-41). This argument is based on the proposition that the property, payroll and sales of the foreign subsidiaries from which the dividends are received generate this income (Appellant's Br. at 40), and not Woolworth's own activities, *Id.* at 36. As indicated in III above in this brief, this proposition ignores the fact that the taxation of dividends is not the taxation of the profits of the payor corporations. It also bases its apportionment relief argument on the assumption that its New Mexico tax liability is higher than if its subsidiaries were operated as divisions of Woolworth (Appellant's Br. at 32, 41). There is nothing in the record to support this. Nothing appears in the record to establish

[22]Woolworth characterizes its income from the stock investments in question as dividends, exchange gain and gross-up. While the inclusion of each one of these items in apportionable income may require some different analysis in terms of modification of the UDITPA apportionment formula, inasmuch as Woolworth has taken the position that they should all be treated as "dividends" from its foreign subsidiaries, we will do likewise in response to Woolworth's argument.

that its New Mexico tax liability would have been higher if its subsidiaries had been operated as divisions. Nor is this argument based on a factual showing that the UDITPA apportionment formula attributes extra-territorial income to New Mexico. Rather, Woolworth simply argues based on the foregoing untenable premises, that the apportionment result here in issue is "patently arbitrary" (Appellant's Br. at 38), an argument so lacking in merit that it was not raised in *Mobil*.[23]

The fact that Woolworth has not established by clear and cogent evidence that the UDITPA apportionment formula, as applied here, taxes extra-territorial values or income, is dispositive of its due process apportionment formula modification argument.[24] Nothing in *Mobil* changes one *iota* of burden imposed on Woolworth to establish by clear and cogent evidence that the UDITPA apportionment formula, as applied here, taxes extra-territorial income or values. The *Mobil* Court reaffirmed this burden of proof requirement when it noted that *Mobil* had

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[23]In our response to this argument, we are not suggesting that, on an appropriate factual showing, Woolworth might not have been entitled to appropriate apportionment relief. Here, however, Woolworth has made no such factual showing nor claim for apportionment relief. Rather, it relies solely on its contention that it is entitled, as a matter of due process, to some apportionment relief because the apportionment of the dividends in question under the UDITPA apportionment formula is "patently arbitrary" as a matter of law. (Appellant's Br. at 38.) While it bases its claim for apportionment relief by analogy to "combined reporting" results (the same results as if its subsidiaries were operated as divisions) it does not here seek to be permitted to file its New Mexico return in question by the "combined reporting" method (which apparently New Mexico would have permitted it to do under the circumstances of this case). Rather, it takes the positions (1) that a "combined report" would be unconstitutional and (2) it did not conduct a unitary business with the payor corporations for the year in question. (Appellant's Br. at 37.)

[24]*See, e. g., Exxon, supra; Moorman Mfg. Co., supra; Norfolk & Western Ry. Co., supra; Hans Rees' Sons, Inc., supra.*

not proved that its Vermont income tax liability was "out of all appropriate proportion to the business transacted by the appellant [Mobil] in that state [Vermont]." 445 U.S. at 437 (bracketed material added).

Assuming, arguendo, that the clear and cogent evidence standard is not applicable here, to determine the constitutionality of the UDITPA apportionment formula and that the "combined reporting" or "divisional operations" standard is, still, Woolworth has not established that it is entitled to any apportionment relief. As stated above, it has not shown that the UDITPA apportionment formula, as applied here, assigned any more taxable income to New Mexico than would have been the case if it had operated its subsidiaries as divisions or if it had filed on the basis of a "combined report" for the tax year in question. The facts are (1) that the tax consequences which follow from the apportionability of dividends have no direct relationship to the tax consequences of "combined reporting;" and (2) that neither of these methods have the same tax consequences which follow from inclusion of the payor's factors in the payees apportionment formula, as suggested by Woolworth, if dividends are included in apportionable income. This is amply demonstrated by the examples set forth in our *amicus curiae* brief at 18-22 in the tandem case of *ASARCO v. Idaho State Tax Comm'n,* No. 80-2015.[25] Those examples need not be repeated here. As those examples illustrate, the inclusion of dividends in apportionable income, without formula modification, may result in the attribution of less net taxable income to New Mex-

[25]A "combined report" result is comparable to the result of divisional operations. Combining Woolworth's subsidiaries and affiliates to determine Woolworth's income tax liability is the same as though those subsidiaries and affiliates had been operated as divisions. Therefore, the "combined reporting" examples in our *ASARCO* brief are equally applicable here.

ico than a "combined report." Furthermore, the inclusion of dividends in apportionable income, subject to the apportionment formula modification suggested by Woolworth, may be equivalent to the total exemption of dividends or may even reduce income apportionable to New Mexico below that which would be apportionable to New Mexico if dividends were exempt or completely eliminated from apportionable income.[26]

In further response to Woolworth's apportionment formula modification argument, it is significant to note the following: dividends are paid out of accumulated book earnings and profits and not current taxable net income. The corporation may pay substantial dividends out of accumulated book earnings and profits, or even current book income, and yet have no current taxable net income at all. Furthermore, accumulated earnings and profits are determined after the deduction of taxes on or measured by net income while net taxable income for state tax purposes is generally computed without the deduction of taxes on or measured by net income. Also, dividends are not necessarily paid from the profits of the business operations of the payor corporations. The accumulated earnings and profits of a dividend payor

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[26]Although not suggested by Woolworth in this case, nor by ASARCO in the tandem *ASARCO* case, No. 80-2015, it has been suggested that, if income from intangibles are apportionable, the formula should include the value of the stock in the denominator of the property factor (in both *ASARCO* and *Woolworth*, the income from the stock investments and other intangibles was included in the sales factor). Any such adjustment would be based on the erroneous conclusions that a part of the income should be assigned "nowhere" or that some state, such as the commercial domicile, has a greater claim to income of intangibles associated with a unitary business than the states where the business is conducted, including the commercial domicile, as reflected by the UDITPA apportionment factors. Furthermore, the difficulties with such an apportionment adjustment is comparable to the difficulties with the formula adjustment, suggested by ASARCO in No. 80-2015 and by Woolworth in this case.

corporation may derive from income from its own ownership of intangibles, including stock investments in its own subsidiary and affiliated corporations. In fact, dividends may be received from a corporation that conducts no business whatsoever (a holding company) which is affiliated with the taxpayer. A logical extension of Woolworth's argument could require the tracing of dividends through a myraid of second, third and even other tier corporations to find the true source of dividends for apportionment purposes. Such tracing might even reveal that the business operations which produced the dividends was that of the payor corporation itself.[27]

Thus, there is no factual validity to Woolworth's conclusion that the inclusion of the income from the stock investments in question in apportionable income is "patently arbitrary" on its face as compared to its potential New Mexico tax liability for the year in question if it had operated subsidiaries as divisions or had filed its New Mexico return by the "combined reporting" method. Nor is the argument valid as a matter of law. As applied in the instant case, the UDITPA apportionment formula simply assigns income rationally related to Woolworth's

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[27]For example, assume that M. I. M., whose dividends are involved in *ASARCO*, No. 80-2015, owns stock in ASARCO (which we understand it does). Some portions of M. I. M. dividends paid to ASARCO would then be traceable to ASARCO's own business operations. As a further example, assume that Corp. A developed a valuable patent as part of its research and development activities in the United States and then formed Subsidiary B in a tax haven country to which it transferred this patent. Assume further that Corp. A paid Subsidiary B for the use of the patent (deductible as a business expense) and then received dividends from Subsidiary B's patent income. In such circumstances, it is clear that the dividends are directly traceable to the business operations of Corp. A. (*See Dittler Bros., Inc. v. Commissioner*, 72 T. C. 896 (1979).)

unitary business to where that business is done as reflected by the location of the tangible property, payroll and receipts of that business. The inherent validity of a formula employing these factors was recognized in *Butler Bros., supra,* 315 U. S. at 509 and in *General Motors v. District of Columbia,* 380 U. S. 553, 561 (1965).

V. Mobil Reaffirmed and Followed the Unitary Business Principle, as Set Forth and Applied in the Previous Decisions of This Court, and Specifically Rejected the Argument that There was Something Constitutionally Different about the Apportionability of Dividends that Distinguished this Class of Income from Other Classes of Income.

As a due process decision, *Mobil* only decided whether there was something different about dividends from foreign affiliated corporations "that precludes, as a constitutional matter, state taxation of that income by the apportionment method." 445 U. S. at 435. *Mobil* decided that there was no such difference and that *Mobil* had failed to demonstrate why dividends from its foreign affiliates should be treated any differently than its operating income for apportionment purposes. 445 U. S. at 447-48. *Mobil* held that the dividends there in question were apportionable because Mobil failed to offer any proof "that would raise the question of nonapportionability." 445 U. S. at 422 (emphasis added.)[28]

When the *Mobil* Court concluded that the "linchpin of apportionability in the field of state income taxation

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[28]The *Mobil* Court found that Mobil failed to sustain this burden not only in regard to dividends from its subsidiaries, but also in regard to the dividends from its miscellaneous stock investments referred to in the *Mobil* dissent, 445 U. S. at 456 n. 16, and from its 10% investment in ARAMCO stock. These facts, conflict with Woolworth's argument that *Mobil*

(Continued on next page)

is the unitary-business principle," 445 U. S. at 439, and that this principle controls the apportionability of dividends, *Id.* at 449, it simply refused to apply a different due process standard to determine the apportionability of dividends or other income from intangibles than the due process standard applicable to all other classes of income. It specifically held that the unitary-business principle, as set forth in its prior decisions, was controlling as to the apportionment of all classes of income. *Id.* at 439. In no sense did it hold, contrary to settled law (*Darnell v. Indiana, supra; Hanley v. Madden, supra*) that income from stock must be attributable to the payor corporations for state income tax apportionment purposes.

Woolworth's argument to the contrary ignores (1) the issue before the Court in *Mobil;* (2) the decisions of this Court relied upon in *Mobil;* (3) the due process burden imposed upon Mobil to establish that its stock investments in *Mobil* were unrelated to its petroleum business, which it conducted in part in Vermont; (4) the express holding of the Court in *Mobil* that the linchpin of apportionability in the state income tax field is the unitary-business principle; and (5) the fact that Mobil obtained no apportionment or other relief in *Mobil.*

The foregoing analysis of the due process portion of *Mobil,* 445 U. S. at 430-42, is supported by the commerce clause portion of *Mobil,* 445 U. S. at 442-46.[29] While holding in *Mobil* that dividends were subject to apportionment under the commerce clause, the Court noted that

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(Continued from the previous page)

limited the apportionability of dividends to dividends from payor's corporations which had conducted a unitary business with Mobil.

[29]Inasmuch as due process and commerce clause issues are interrelated, *International Harvester Co. v. Department of Treasury,* 332 U. S. 340, 353 (1944), disposition of the commerce clause issue in *Mobil* is relevant for due process purposes.

when intangible property is related to more than one jurisdiction, apportionment of income from intangibles is the preferred method rather than specific allocation, 445 U. S. at 444-45, because

> the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges conferred by several States. (445 U. S. at 446).

It then concluded in *Mobil* that "[t]hese are the circumstances in which apportionment is ordinarily the accepted method." *Id.* The foregoing interpretation of Mobil is supported by *Exxon, supra,* the cases relied on in *Exxon* and *Mobil, supra,* and numerous state income tax cases which have applied the unitary-business principle in determining the apportionability of income from intangibles, all support the foregoing interpretation of *Mobil.*[30]

Also, the Commission's UDITPA regulations, adopted by New Mexico and relied on by the court below,[31] are consistent with the foregoing cases, including *Mobil.*

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[30]See, e. g., *Qualls v. Montgomery Ward & Co.,* 266 Ark. 207, 585 S. W. 2d 18 (1979); *Times Mirror Co. v. Franchise Tax Bd.,* 102 Cal. App. 3d 872, 162 Cal. Rptr. 630 (1980); *Lone Star Steel Co. v. Dolan,* No. 79CA0506 (Colo. App. Sept. 24, 1981), *cert. docketed,* No. 81 SC 382 (Colo. Sup. Ct. Dec. 4, 1981); *Xerox Corp. v. Comptroller of the Treasury,* 428 A. 2d 1208 (Md. 1981); *Albany Int'l Corp. v. Halperin,* — Me. —, 388 A. 2d 902 (1978); *W. R. Grace & Co. v. Commissioner of Revenue,* — Mass. —, 393 N. E. 2d 300 (1979); *Great Lakes Pipe Line Co., supra; Montgomery Ward & Co. v. Commissioner of Taxes,* 276 Minn. 479, 151 N. W. 2d 294 (1967); *Montana Dep't of Revenue v. American Smelting & Ref. Co.,* 173 Mont. 316, 567 P. 2d 901 (1977), *appeal dismissed,* 434 U. S. 1042 (1978); *F. W. Woolworth Co. v. Director of Division of Taxation,* 45 N. J. 466, 213 A. 2d 1 (1965); *Champion Int'l Corp. v. Bureau of Revenue,* 88 N. M. 411, 54 P. 2d 1300 (1975); *Sperry & Hutchinson Co. v. Department of Revenue,* 279 Or. 329, 527 P. 2d 729 (1974); *F. W. Woolworth Co. v. Commissioner of Taxes,* 130 Vt. 544, 298 A. 2d 839 (1972); *Gulf Oil Corp. v. Morrison,* 120 Vt. 324, 141 A. 2d 671 (1958).

[31]J. S. at 12a-13a; 7 Multistate Tax Comm'n Ann. Rept. app. J at 64-69 (1973-1974); see footnote 11, supra.

In arguing that the dividends in question are not apportionable under *Mobil,* Woolworth fails to note that the relationship of a payor's activities with that of a payee, which this Court considered in *Mobil,* is only relevant, for apportionability purposes, to determine whether the stock investments are rationally related in a due process sense to the payor's own unitary business. Woolworth admits this, in part, when it concedes

> There may be situations, not considered in *Mobil* and not present here, in which it would be appropriate to focus only on the taxpayer's own activities, without regard to the underlying activties of the company paying the dividends. (Appellant's Br. at 18-19).

Woolworth then sets forth an example of a securities dealer. *Id.* The only difference that we can discern between the securities dealers "situation" and other situations is the unitary business principle. Likewise, the only reason dividends are apportionable under UDITPA is because they are from stock investments which are rationally related to the taxpayer's regular trade or business operations. N. M. S. A. § 7-4-2 (A); UDITPA § 1 (a) (J. S. 12a-14a).

This UDITPA test as to apportionability conforms to the unitary business principle of *Mobil* which requires Woolworth to show "in order to establish that its dividend income is not subject to an apportioned tax . . . is that the income was earned in the course of activities unrelated to" its retailing activities and investments in New Mexico. 445 U. S. at 439. Woolworth has failed to make this showing. In the case at bar, since there is substantial evidence that the investments in question are in affiliated and subsidiary corporations whose activities are related to Woolworth's unitary business (J. A. at 19a-20a), like Mobil,

Woolworth has failed to establish a lack of due process connection between its stock in question and its unitary business. Thus, *Mobil* supports the apportionability of the dividends in question. Also, since Woolworth has not sustained the burden of proof affirmed in *Mobil*, it is entitled to no apportionment relief under *Mobil*.

VI. Woolworth's Commerce Clause Argument Lacks Merit Because It Is Based on An Erroneous Interpretation and Application of Japan Line Ltd. v. Los Angeles, 441 U. S. 434 (1979) and Erroneous Assumptions and Facts Not Supported by the Record.

On pages 25-28 of our *amicus* brief in the tandem case of *ASARCO v. Idaho State Tax Comm'n*, No. 80-2015, we have set forth the reasons why we believe ASARCO's commerce clause argument lacks merit. Since Woolworth's argument is identical to ASARCO's argument in No. 80-2015, we refer to our response in that case to support our position here that Woolworth's commerce clause argument lacks merit. As there indicated, one reason it lacks merit is because this court in *Mobil* held that *Japan Line Ltd., supra,* under facts comparable to those here, was not relevant.

CONCLUSION

For the reasons stated herein and in the tandem case of *ASARCO,* No. 80-2015, it is respectfully requested that this Court affirm the decision below of the Supreme Court of New Mexico.

Respectfully submitted,

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No. 80-1745

IN THE

Supreme Court of the United States

October Term, 1981

F. W. WOOLWORTH CO., *Appellant*

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO, *Appellee.*

On Appeal from the Supreme Court of New Mexico

BRIEF OF AMICUS CURIAE STATE OF VERMONT IN SUPPORT OF APPELLEE'S BRIEF

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BRIEF OF AMICUS CURIAE STATE OF VERMONT IN SUPPORT OF APPELLEE'S BRIEF

INTRODUCTORY STATEMENT

This brief is submitted by the State of Vermont as amicus curiae in support of the Appellee. An identical brief has been submitted in support of the Appellee in *Asarco, Incorporated (formerly American Smelting and Refining Company) v. Idaho State Tax Commissioner, prob. jusis. noted,* No. 80-2015 (U.S. Oct. 5, 1981).

STATEMENT OF INTEREST

The State of Vermont imposes a tax on the net income of corporations doing business within the state. VT. STAT. ANN. TIT. 32, §5832 (1981). Vermont net income is calculated by using the current federal definition of taxable income, with some adjustments. *Id.* §5811(18). Because federal taxable income includes dividends from a corporation's foreign subsidiaries, such dividends are also included in Vermont's tax base.

When a corporation operates in other jurisdictions as well as in Vermont, an apportionment formula is applied to the corporation's income to determine "a fair and equitable portion" to be taxed by Vermont. *Id.* §5833. Vermont's apportionment formula is not automatically adjusted when dividends from foreign subsidiaries are received by a corporation taxed in Vermont, although the Commissioner of Taxes may modify the formula if it does not fairly represent the extent of a corporation's business activities in the state. *Id.* §5833(b).

Vermont has a direct and significant interest in the outcome of this case because it would be barred from including certain dividends in its tax base, or, alternatively, would be forced to modify its apportionment formula in certain cases, if the Appellant's Due Process and Commerce Clause arguments are upheld. Vermont's brief will discuss only the propriety, under the Due Process Clause, of including dividends in apportionable income and the necessity of modifying the apportionment formula if dividend income is included.

SUMMARY OF ARGUMENT

When a state imposes a tax on the income of a multinational corporation doing business within its borders, the only valid question under the Due Process Clause is whether the tax imposed is out of all proportion to the benefits conferred on the corporation by the state. The application of an apportionment formula to a corporation's operating and investment income is a reasonable method of apportioning profits among the states. Dividends, as part of a corporation's investment income, may be considered in ascertaining the profitability of a corporation and are apportionable under long-standing due process analysis.

As long as an apportionment formula produces a tax reasonably related to the activities of a corporation within the state, no modification to the formula to take into account the property, payroll and sales factors of a dividend payor is justified under the Due Process Clause.

ARGUMENT

I. There is no due process bar to the inclusion of dividends in the taxable income of a corporation doing business within a state so long as the income is fairly apportioned.

A state may tax the income of a corporation engaged in interstate commerce provided a minimal connection or "nexus" exists between the taxing state and the interstate activities of the corporation. *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 219 (1980). The nexus requirement is met if the corporation avails itself of the substantial privilege of carrying on

business within the state. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 437 (1980) (hereinafter cited as *Mobil*). Once nexus is established, "[s]o far as due process is concerned the only question is whether the tax in practical operation has relation to opportunities, benefits, or protection conferred or afforded by the taxing state." *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 325 n.5 (1968) (quoting *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169, 174 (1949)).

It is well established that, when a corporation does business within a state, the corporation receives the substantial benefits of a state's services, including "police and fire protection, the benefit of a trained work force, and 'the advantages of a civilized society.'" *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. at 228 (citations omitted). The application of a reasonable apportionment formula to the income of an interstate corporation ensures attribution of a portion of income to each state in direct relation to the corporation's activities within the state. Such an attribution is reasonable in light of the privileges afforded by the state to the operating corporation and is a guarantee that the proper value is placed on the state's services in relation to the corporation's profitability.

The proper focus of due process analysis is not what goes into the corporation's taxable income, but what the results are after a state's apportionment formula has been applied to that income. *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 273-74 (1978). The source of a particular item of income is unimportant; the test is whether the tax assessed after application of the apportionment formula is in proportion to the benefits con-

ferred by the state. *Mobil*, 445 U.S. at 437; *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931).

In Vermont's view, both operating and investment income contribute to the overall corporate enterprise.[1] Where a portion of the total corporate business is being conducted in Vermont, it is appropriate to include all income in the tax base as long as it is properly apportioned. *See Mobil Oil Corp. v. Commissioner of Taxes*, 136 Vt. 545, 552, 394 A.2d 1147, 1151 (1978), *aff'd*, 445 U.S. 425 (1980); *F. W. Woolworth Co. v. Commissioner of Taxes*, 130 Vt. 544, 549, 298 A.2d 839, 841 (1972).

When a state extends its services to a corporation, it is providing an atmosphere in which a corporation may prosper, whether by extensive management of operating assets, manipulation of a market for its goods, or reinvestment of its profits. A corporation's income may include, in addition to operating income, long- and short-term investment income. Operating income represents the current profits of the company's active business, while investment income is a result of a temporary or long-term diversion of operating profits to investments available to, or supportive of, the operating business.

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1 Vermont and twenty-one other states employ the federal definition of income as the starting point for their corporate income taxes. Federation of Tax Administrators, Research Memorandum 527, Federal Starting Point Laws: State Personal and Corporate Income Taxes (November, 1981). The use of the federal income definition provides administrative convenience to the states because it is widely accepted and refined by many rulings, regulations and court opinions. Adherence to the federal definition results in consistency of treatment at the state level, offering predictability and uniformity, as both intrastate and interstate corporations will include the same items of operating and investment income.

When a state chooses to include an interstate corporation's investment income in determining its apportionable income, the state is not taxing extraterritorial values. *See Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-21 (1920). The investment income represents the income of the corporation which holds the investment; its inclusion is not an attempt by the state to tax the income of the operating business which produces the income for the investor. For example, inclusion in income of interest earned on bank certificates of deposit measures the investor's profitability; such inclusion is not an attempt to reach the bank's income. Similarly, the inclusion of dividends from a foreign corporation in the income of a corporate shareholder measures the investment profit of the shareholder; the inclusion is not an attempt to tax the foreign corporation's income.

While the Court in *Mobil* specifically reserved decision on the apportionability of dividends where there is no underlying unitary business as the source of the dividends, there was no real discussion in the opinion of the effect investment income has on the overall operations of a business. *Mobil*, 445 U.S. at 442. This Court has recognized that intangible property held by a multistate corporation contributes to the overall business carried on within each state:

> Financial power inherent in possession of assets may be applied, with flexibility, at whatever point within or without the state the managers of the business may determine. . . . The weight, in determining the value of the intrastate privilege, given the property

> beyond the state's boundaries, is but a recognition of the very real effect its existence has upon the value of the privilege granted within the taxing state.

Ford Motor Co. v. Beauchamp, 308 U.S. 331, 336 (1939).

The Court might well find that the "business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing state," *Mobil*, 445 U.S. at 442, and still find that the *dividends themselves* are used by the recipient in its business and are fully apportionable. As long as the results produced by an apportionment formula are fair, the amounts included in the apportionable base are beyond criticism under the Due Process Clause.

II. The inclusion of dividends in pre-apportioned income does not require adjustment of a state's apportionment formula to reflect the property, payroll and sales of the dividend payor.

As discussed above, due process analysis examines the privileges and protections invoked by a corporation when it does business within a state and what that state can ask in return by way of a corporate income tax. Both operating and investment income may be considered in measuring the tax a corporation should pay to a state, as long as the resulting tax bears a rational relationship to the activities conducted within the state. Since an apportionment formula spreads investment income among taxing states on the basis of operating factors (property, payroll and sales), the resulting tax is *per se* a reasonable extraction by each state.

A demand that the property, payroll and sales factors of a dividend-paying corporation be reflected in a state's apportionment formula is really a repetition of the argument that dividends should be excluded from income. If the source of income has no due process bearing because the result of apportionment is what is to be considered, then the factors of the dividend-paying corporation are irrrelevant unless the result of apportionment is unfair. Showing that a corporation would pay less tax if the factors of the dividend-paying corporation were considered does not prove that the apportionment formula is unfair; an inclusion in income of interest from a bank certificate of deposit would not call for a modification of an apportionment formula to reflect the bank's factors, although such an action would surely reduce the operating company's tax. What must be shown is that the tax is out of all proportion to the benefits received. *Moorman Manufacturing Co. v. Bair*, 437 U.S. at 274; *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. at 135. The Appellant has failed to show that the tax imposed exceeded the benefits conferred and was unfair. Absent proof of such unfairness, the apportionment formula must be upheld.

CONCLUSION

The Due Process Clause requires only that a corporation have a minimal connection with a state before a tax on income may be imposed. The apportionment of a multistate corporation's income guarantees that the tax imposed will be reasonably related to the activities of the corporation within the state. Dividend income may be included in the income subject to apportionment because it reflects the profits of the entire corporate enterprise

which is carried on, in part, within the state. No modification of the apportionment formula is required where dividends are included in apportionable income unless the formula produces an unfair result, out of all proportion to the benefits received by the operating company.

Dated at Montpelier, Vermont, this 15th day of January, 1982.

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CERTIFICATE OF SERVICE

I hereby certify that on this 15th day of January, 1982, three copies of this brief were mailed, with first class postage prepaid, to George W. Beatty, 1200 18th Street, N.W., Washington, D.C. 20036, Counsel for Appellant, and to Sarah E. Bennett, Post Office Box 630, Sante Fe, New Mexico 87509, Counsel for Appellee. I further certify that all parties required to be served have been served.

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